CHAPTER 1

GENERAL PRINCIPLES OF FINANCIAL PLANNING

TOPIC 1: FINANCIAL PLANNING PROCESS

1. Purpose, benefits, and components

A. The purpose of financial planning is to provide sound, coordinated financial advice to individuals and their families.

2. Steps

A. Establishing client-planner relationships sets the expectations of the parties and lays the groundwork for developing the trust necessary for successful financial planning

(1) Identifying the service(s) to be provided
(2) Disclosing the financial planning practitioner's compensation arrangement(s)
(3) Determining the client's and the financial planning practitioner's responsibilities
(4) Establishing the duration of the engagement
(5) Providing any additional information necessary to define or limit the scope of the process

B. Gathering client data and determining goals and expectations. A financial plan is only as good as the data collected and the assumptions on which that data are based. Both quantitative and qualitative data are used to establish a client's goals and objectives.

(1) Quantitative data tells you where the client is and what it will take to get the client to a specific financial goal.
(2) Quantitative data is found using a fact-finding questionnaire. Qualitative data tells you why the client wants to reach the goal, what will make him or her work toward it, and what the client is not likely to do. Qualitative data is obtained by conducting a goals and objectives interview.
(3) Goals are broad-based projections of a client's aspirations. For example, a client's goal may be to retire rich.
(4) Objectives are quantifiable ways of achieving goals over a specified time period. For example, saving $5 million by age 65 is an objective, whereas retiring rich is the goal.

C. Determining the client's financial status by analyzing and evaluating his or her general financial status, special needs, insurance and risk management, investments, taxation, employee benefits, retirement, and/or estate planning
D. Developing and presenting the financial plan
E. Implementing the financial plan
F. Motivate the client. Draw on outside experts as needed.
G. Monitoring the financial plan

(1) Evaluate the performance. Review changes in client's circumstances and tax laws. Revisit other steps as necessary.

3. Responsibilities

(1) Financial planner. Evaluate client needs, explain financial planning concepts and clarify client goals, analyze client circumstances and prepare financial plans, and implement and monitor financial plans.
(2) Client. Express concerns, hopes, and goals; do not procrastinate; be honest with your answers to questions; live within your current income and do not live up to or beyond it; be open to formulating a financial plan and identifying strategies to reach goals and objectives.
(3) Other advisers. The planner may seek out the help of others when implementing the financial plan. Their responsibilities fall within the realm of their expertise.

TOPIC 2: CFP BOARD'S CODE OF ETHICS AND PROFESSIONAL RESPONSIBILITY AND DISCIPLINARY RULES AND PROCEDURES

The following contains wording from both the *Code of Ethics* and *Professional Responsibility and Disciplinary Rules and Procedures* (© 2009 by the Certified Financial Planner Board of Standards, Inc.). It is imperative that you read the entire Code of Ethics and Practice Standards to ensure the background needed to answer questions pertaining to topics 2 and 3. To download both, please visit the CFP Board's website at www.cfp.net.

Code Terminology

This terminology applies only for purposes of interpreting and/or enforcing the CFP Board's Code of Ethics, Rules of Conduct, Practice Standards, and Disciplinary Rules.

"**Certificant**" denotes individuals who are currently certified by the CFP Board.

"**Certificant's employer**" denotes any person or entity that employs a certificant or registrant to provide services to a third party on behalf of the employer, including certificants and registrants who are retained as independent contractors or agents.

"**CFP Board**" denotes Certified Financial Planner Board of Standards, Inc.

"**Client**" denotes a person or persons (or entity) who engage(s) a certificant and for whom professional services are rendered. Where the services of the certificant are provided to an entity (corporation, trust, partnership, estate, etc.), the client is the entity acting through its legally authorized representative.

"**Commission**" denotes the compensation generated from a transaction involving a product or service and received by an agent or broker, usually calculated as a percentage on the amount of his or her sales or purchase transactions. This includes 12b-1 fees, trailing commissions, surrender charges, and contingent deferred sales charges.

"**Compensation**" is any nontrivial economic benefit, whether monetary or nonmonetary, that a certificant or related party receives or is entitled to receive for providing professional activities.

A "**conflict of interest**" exists when a certificant's financial, business, property, and/or personal interests, relationships, or circumstances reasonably may impair his or her ability to offer objective advice, recommendations, or services.

"**Fee-only**." A certificant may describe his or her practice as fee-only if, and only if, all of the certificant's compensation from all of his or her client work comes exclusively from the clients in the form of fixed, flat, hourly, percentage, or performance-based fees.

A "**fiduciary**" is one who acts in utmost good faith, in a manner he or she reasonably believes to be in the best interest of the client.

A "**financial planning engagement**" exists when a certificant performs any type of mutually agreed-upon financial planning service for a client.

A "**financial planning practitioner**" is a person who engages in financial planning using the financial planning process in working with clients.

"**Personal financial planning**" or "financial planning" denotes the process of determining whether and how an individual can meet life goals through the proper management of financial resources. Financial planning integrates the financial planning process with the financial planning subject areas. In determining whether the certificant is providing financial planning or material elements of the financial planning process, issues that may be considered include but are not limited to:

- The client's understanding and intent in engaging the certificant.
- The degree to which multiple financial planning subject areas are involved.

- The comprehensiveness of data gathering.
- The breadth and depth of recommendations.

Financial planning may occur even if the elements are not provided to a client simultaneously, are delivered over a period of time, or are delivered as distinct subject areas. It is not necessary to provide a written financial plan to engage in financial planning.

"**Personal financial planning process**" or "financial planning process" denotes the process that typically includes, but is not limited to, some or all of these six elements:

1. Establishing and defining the client-planner relationship.
2. Gathering client data including goals.
3. Analyzing and evaluating the client's current financial status.
4. Developing and presenting recommendations and/or alternatives.
5. Implementing the recommendations.
6. Monitoring the recommendations.

"**Personal financial planning subject areas**" or "financial planning subject areas" denotes the basic subject fields covered in the financial planning process, which typically include, but are not limited to:

- Financial statement preparation and analysis (including cash flow analysis/planning and budgeting).
- Investment planning (including portfolio design, i.e., asset allocation and portfolio management).
- Income tax planning.
- Education planning.
- Risk management.
- Retirement planning.
- Estate planning.

"**Registrant**" denotes individuals who are not currently certified but have been certified by the CFP Board in the past and have an entitlement, direct or indirect, to potentially use the CFP® marks. This includes individuals who have relinquished their certification and who are eligible for reinstatement without being required to pass the current CFP® Certification Examination. The Rules of Conduct apply to registrants when the conduct at issue occurred at a time when the registrant was certified; the CFP Board has jurisdiction to investigate such conduct.

Code of Ethics and Professional Responsibility

The CFP Board adopted the Code of Ethics to establish the highest principles and standards. These Principles are general statements expressing the ethical and professional ideals that certificants and registrants are expected to display in their professional activities. As such, the Principles are aspirational in character and provide a source of guidance for certificants and registrants. The Principles form the basis of CFP Board's Rules of Conduct, Practice Standards, and Disciplinary Rules, and these documents together reflect the CFP Board's recognition of certificants' and registrants' responsibilities to the public, clients, colleagues, and employers.

Principle 1—Integrity
Principle 2—Objectivity
Principle 3—Competence
Principle 4—Fairness

Principle 5—Confidentiality
Principle 6—Professionalism
Principle 7—Diligence

The way I help my students remember the principles is through the phrase "**I O**nly **C**are **f**or **C**ash **P**aid **D**aily," where the first letters stand for the names of the principles.

"I" stands for "Integrity" under principle 1.
"O" stands for "Objectivity" under principle 2.
"C" stands for "Competence" under principle 3.
"F" stands for "Fairness" under principle 4.
"C" stands for "Confidentiality" under principle 5.
"P" stands for "Professionalism" under principle 6.
"D" stands for "Diligence" under principle 7.

Question: You are working with a divorced wife whose main source of income is from her ex-husband's business as per the divorce decree. The ex-husband visits your office and informs you that he is going out of business. What is your obligation to the wife?

A. Drop the wife as a client and withdraw from the engagement.
B. Work with both the wife and the ex-husband.
C. Fire the wife and keep the ex-husband.
D. Don't tell the wife what you know.*

Rules of Conduct

The Rules of Conduct establish the high standards expected of certificants and describe the level of professionalism required of certificants. The Rules of Conduct are binding on all certificants, regardless of their title, position, type of employment, or method of compensation, and they govern all those who have the right to use the CFP® marks, whether or not those marks are actually used. The universe of activities engaged in by a certificant is diverse, and a certificant may perform all, some, or none of the typical services provided by financial planning professionals. Some Rules may not be applicable to a certificant's specific activity. As a result, when considering the Rules of Conduct, the certificant must determine whether a specific Rule is applicable to those services. A certificant will be deemed to be in compliance with these Rules if that certificant can demonstrate that his or her employer completed the required action.

Violations of the Rules of Conduct may subject a certificant or registrant to discipline. Because the CFP Board is a certifying and standards-setting body for those individuals who have met and continue to meet the CFP Board's initial and ongoing certification requirements, discipline extends to the rights of registrants and certificants to use the CFP® marks. Thus, the Rules are not designed to be a basis for legal liability to any third party.

1. Defining the Relationship with the Prospective Client or Client

1.1 The certificant and the prospective client or client shall mutually agree upon the services to be provided by the certificant.

1.2 If the certificant's services include financial planning or material elements of the financial planning process, prior to entering into an agreement, the certificant shall provide written information and/or discuss with the prospective client or client the following:

(a) The obligations and responsibilities of each party under the agreement with respect to:

(i) Defining goals, needs, and objectives,
(ii) Gathering and providing appropriate data,
(iii) Examining the result of the current course of action without changes,
(iv) The formulation of any recommended actions,
(v) Implementation responsibilities, and
(vi) Monitoring responsibilities.

(b) Compensation that any party to the agreement or any legal affiliate to a party to the agreement will or could receive under the terms of the agreement, and factors or terms that determine costs, how decisions benefit the certificant, and the relative benefit to the certificant.
(c) Terms under which the agreement permits the certificant to offer proprietary products.
(d) Terms under which the certificant will use other entities to meet any of the agreement's obligations.

If the certificant provides the above information in writing, the certificant shall encourage the prospective client or client to review the information and offer to answer any questions that the prospective client or client may have.

1.3 If the services include financial planning or material elements of the financial planning process, the certificant or the certificant's employer shall enter into a written agreement governing the financial planning services ("Agreement"). The Agreement shall specify:

The parties to the Agreement,
The date of the Agreement and its duration,
How and on what terms each party can terminate the Agreement, and
The services to be provided as part of the Agreement.

The Agreement may consist of multiple written documents. Written documentation that includes the aforementioned elements and is used by a certificant or certificant's employer in compliance with state and/or federal law, or the rules or regulations of any applicable self-regulatory organization, such as a Form ADV or other disclosure, shall satisfy the requirements of this Rule.

1.4 A certificant shall at all times place the interest of the client ahead of his or her own. When the certificant provides financial planning or material elements of the financial planning process, the certificant owes to the client the duty of care of a fiduciary as defined by the CFP Board.

2. Information Disclosed to Prospective Clients and Clients

2.1 A certificant shall not communicate, directly or indirectly, to clients or prospective clients any false or misleading information directly or indirectly related to the certificant's professional qualifications or services. A certificant shall not mislead any parties about the potential benefits of the certificant's service. A certificant shall not fail to disclose or otherwise omit facts where that disclosure is necessary to avoid misleading clients.
2.2 A certificant shall disclose to a prospective client or client the following information:

(a) An accurate and understandable description of the compensation arrangements being offered. This description must include:

(i) Information related to costs and compensation to the certificant and/or the certificant's employer, and

(ii) Terms under which the certificant and/or the certificant's employer may receive any other sources of compensation, and if so, what the sources of these payments are and on what they are based.

(b) A general summary of likely conflicts of interest between the client and the certificant, the certificant's employer, or any affiliates or third parties, including, but not limited to, information about any familial, contractual, or agency relationship of the certificant or the certificant's employer that has a potential to materially affect the relationship.
(c) Any information about the certificant or the certificant's employer that could reasonably be expected to materially affect the client's decision to engage the certificant that the client might reasonably want to know in establishing the scope and nature of the relationship, including but not limited to information about the certificant's areas of expertise.
(d) Contact information for the certificant and, if applicable, the certificant's employer.
(e) If the services include financial planning or material elements of the financial planning process, these disclosures must be in writing. The written disclosures may consist of multiple written documents. Written disclosures used by a certificant or certificant's employer that include the elements listed earlier, and are used in compliance with state or federal laws, or the rules or requirements of any applicable self-regulatory organization, such as a Form ADV or other disclosure documents, shall satisfy the requirements of this Rule.

The certificant shall timely disclose to the client any material changes to the aforementioned information.

3. Prospective Client and Client Information and Property

3.1 A certificant shall treat information as confidential except as required in response to proper legal process, as necessitated by obligations to a certificant's employer or partners, to defend against charges of wrongdoing, in connection with a civil dispute, or as needed to perform the services.
3.2 A certificant shall take prudent steps to protect the security of information and property, including the security of stored information, whether physically or electronically, that is within the certificant's control.
3.3 A certificant shall obtain the information necessary to fulfill his or her obligations. If a certificant cannot obtain the necessary information, the certificant shall inform the prospective client or client of any and all material deficiencies.
3.4 A certificant shall clearly identify the assets, if any, over which the certificant will take custody, exercise investment discretion, or exercise supervision.
3.5 A certificant shall identify and keep complete records of all funds or other property of a client in the custody, or under the discretionary authority, of the certificant.
3.6 A certificant shall not borrow money from a client. Exceptions to this Rule include:

(a) The client is a member of the certificant's immediate family.
(b) The client is an institution in the business of lending money and the borrowing is unrelated to the professional services performed by the certificant.

3.7 A certificant shall not lend money to a client. Exceptions to this Rule include:

(a) The client is a member of the certificant's immediate family.
(b) The certificant is an employee of an institution in the business of lending money and the money lent is that of the institution, not the certificant.

3.8 A certificant shall not commingle a client's property with the property of the certificant or the certificant's employer, unless the commingling is permitted by law or is explicitly authorized and defined in a written agreement between the parties.

3.9 A certificant shall not commingle a client's property with other clients' property unless the commingling is permitted by law or the certificant has both explicit written authorization to do so from each client involved and sufficient record-keeping to track each client's assets accurately.

3.10 A certificant shall return a client's property to the client upon request as soon as practicable or consistent with a time frame specified in an agreement with the client.

4. Obligations to Prospective Clients and Clients

4.1 A certificant shall treat prospective clients and clients fairly and provide professional services with integrity and objectivity.

4.2 A certificant shall offer advice only in those areas in which he or she is competent to do so and shall maintain competence in all areas in which he or she is engaged to provide professional services.

4.3 A certificant shall be in compliance with applicable regulatory requirements governing professional services provided to the client.

4.4 A certificant shall exercise reasonable and prudent professional judgment in providing professional services to clients.

4.5 In addition to the requirements of Rule 1.4, a certificant shall make and/or implement only recommendations that are suitable for the client.

4.6 A certificant shall provide reasonable and prudent professional supervision or direction to any subordinate or third party to whom the certificant assigns responsibility for any client services.

4.7 A certificant shall advise his or her current clients of any certification suspension or revocation he or she receives from the CFP Board.

5. Obligations to Employers

5.1 A certificant who is an employee/agent shall perform professional services with dedication to the lawful objectives of the employer/principal and in accordance with the CFP Board's Code of Ethics.

5.2 A certificant who is an employee/agent shall advise his or her current employer/principal of any certification suspension or revocation he or she receives from the CFP Board.

6. Obligations to the CFP Board

6.1 A certificant shall abide by the terms of all agreements with the CFP Board, including, but not limited to, using the CFP® marks properly and cooperating fully with the CFP Board's trademark and professional review operations and requirements.

6.2 A certificant shall meet all CFP Board requirements, including continuing education requirements, to retain the right to use the CFP® marks.

6.3 A certificant shall notify the CFP Board of changes to contact information, including, but not limited to, e-mail address, telephone number(s), and physical address, within forty-five (45) days.

6.4 A certificant shall notify the CFP Board in writing of any conviction of a crime, except misdemeanor traffic offenses or traffic ordinance violations unless such offense involves the use of alcohol or drugs, or of any professional suspension or bar within ten (10) calendar days after the date on which the certificant is notified of the conviction, suspension, or bar.

6.5 A certificant shall not engage in conduct that reflects adversely on his or her integrity or fitness as a certificant, upon the CFP® marks, or upon the profession.

TOPIC 3: STATEMENT OF PURPOSE FOR FINANCIAL PLANNING PRACTICE STANDARDS

Financial Planning Practice Standards are developed and promulgated by the Certified Financial Planner Board of Standards, Inc. (CFP Board) for the ultimate benefit of consumers of financial planning services.

These Practice Standards are intended to:

- Assure that the practice of financial planning by CERTIFIED FINANCIAL PLANNER™ professionals is based on established norms of practice.
- Advance professionalism in financial planning.
- Enhance the value of the financial planning process.

Compliance with Practice Standards

The practice of financial planning consistent with these Practice Standards is required for certificants who are financial planning practitioners. The Practice Standards are used by the CFP Board's Disciplinary and Ethics Commission and Appeals Committee in evaluating the certificant's conduct to determine if the Rules of Conduct have been violated, based on the Disciplinary Rules established by the CFP Board.

Practice Standards 100 Series

Establishing and Defining the Relationship with the Client

100-1: Defining the Scope of the Engagement
The financial planning practitioner and the client shall mutually define the scope of the engagement before any financial planning service is provided.

Gathering Client Data

200-1: Determining a Client's Personal and Financial Goals, Needs, and Priorities
The financial planning practitioner and the client shall mutually define the client's personal and financial goals, needs, and priorities that are relevant to the scope of the engagement before any recommendation is made and/or implemented.

200-2: Obtaining Quantitative Information and Documents
The financial planning practitioner shall obtain sufficient quantitative information and documents about a client relevant to the scope of the engagement before any recommendation is made and/or implemented.

Analyzing and Evaluating the Client's Financial Status

300-1: Analyzing and Evaluating the Client's Information
A financial planning practitioner shall analyze the information to gain an understanding of the client's financial situation and then evaluate to what extent the client's goals, needs, and priorities can be met by the client's resources and current course of action.

Developing and Presenting the Financial Planning Recommendation(s)

400-1: Identifying and Evaluating Financial Planning Alternative(s)
The financial planning practitioner shall consider sufficient and relevant alternatives to the client's current course of action in an effort to reasonably meet the client's goals, needs, and priorities.

400-2: Developing the Financial Planning Recommendation(s)
The financial planning practitioner shall develop the recommendation(s) based on the selected alternative(s) and the current course of action in an effort to reasonably meet the client's goals, needs, and priorities.

Implementing the Financial Planning Recommendation(s)

500-1: Agreeing on Implementation Responsibilities
The financial planning practitioner and the client shall mutually agree on the implementation responsibilities consistent with the scope of the engagement.

500-2: Selecting Products and Services for Implementation
The financial planning practitioner shall select appropriate products and services that are consistent with the client's goals, needs, and priorities.

Monitoring

600-1: Defining Monitoring Responsibilities
The financial planning practitioner and client shall mutually define monitoring responsibilities.

Disciplinary Rules

The Disciplinary Rules describe the procedures followed by the CFP Board in enforcing the Rules of Conduct. The Disciplinary Rules provide a fair process pursuant to which certificants are given notice of potential violations and an opportunity to be heard by a panel of other professionals.

TOPIC 4: FINANCIAL STATEMENTS

1. **Personal**

   A. Statement of financial position

   (1) A balance sheet is a statement of financial position. It is a financial snapshot of the individual's wealth at a moment in time. It contains three categories: (1) assets, (2) liabilities, and (3) net worth. Net worth measures the client's wealth or equity at a specified period of time (i.e., net worth equals total assets minus total liabilities).

   (a) Net worth increases from the following:

   (i) Appreciation in the value of assets
   (ii) Increase in assets from retaining income
   (iii) Increase in assets from gifts or inheritances
   (iv) Decrease in liabilities through forgiveness

   (b) Net worth is unchanged by the following:

   (i) Paying off debt
   (ii) Buying an asset with cash

(c) Assets and liabilities are indicated at fair market value (FMV), footnotes are used to describe details of assets and liabilities, and property is identified by type of ownership.
(d) Assets are categorized as (1) cash and cash equivalents (checking and savings accounts, money markets), (2) invested assets (stocks, bonds, mutual funds), and (3) use assets (home, furnishings, cars).
(e) Liabilities are categorized as (1) current liabilities (credit card balances) and (2) long-term liabilities (auto loans, real estate mortgages, life insurance loans).

(2) Statement of cash flow

(a) Must indicate the period of coverage, usually a calendar year

(i) Step 1. Estimate the family's annual income.
(ii) Step 2. Develop estimates for both fixed and discretionary expenses.
(iii) Step 3. Determine the excess of shortfall of income within the budget period. Net cash flow equals total income minus total expenses. If net income is positive, the client can increase discretionary expenses.
(iv) Step 4. Consider available methods of increasing income or decreasing expenses.
(v) Step 5. Calculate income and expenses as a percentage of the total to determine a better allocation of resources.

2. Business

A. Balance sheet
B. Income statement
C. Statement of cash flows
D. Pro forma statements

(1) Pro forma statements forecast future balance sheets and cash flow statements. It may make sense to include three different cash flow statements: (1) worst-case budget, based on lowest income and highest expenditures expected; (2) average-case budget, based on reasonable expectations of income and expenses; and (3) best-case budget, based on highest income and lowest expenditures.

TOPIC 5: CASH FLOW MANAGEMENT

1. Budgeting

A. There are two types of budgeting: discretionary and nondiscretionary. Discretionary expenses are flexible and can be prevented or timed. Nondiscretionary or fixed expenses can be changed, but must be paid. Various strategies are used to maximize income and minimize expenses:

2. Budgeting strategies

A. Debt restructuring: The process of paying off all outstanding credit cards by consolidating debt into one low personal line of credit.
B. Asset reallocation: This process involves the change in assets from underperforming assets to more productive investment assets to improve return and income.
C. Expenditure control: The process of reducing consumption expenditures by emphasizing the savings element.
D. Income tax planning: Process of benefiting from proper tax planning incorporating children's assets. The process of saving for a child in a custodial account or trust to benefit from the lower tax rate of the child.

E. Qualified plan vehicles: The process of utilizing a qualified plan to benefit from saving programs and deductibility.
F. Financing strategies: Consolidating credit card debt and student loan debt.
G. Cash-out refinancing: A cash-out refinance will give a new first mortgage by paying off the current first mortgage and provide additional cash. If current mortgage rates are lower than that of the existing first mortgage, a new first mortgage will allow the borrower to save on the current debt. The combined loan to value of 80 percent is recommended to avoid mortgage insurance. Interest is tax deductible, as with all home mortgages.
H. Home equity loans or a home equity line of credit:
I. Loans on the cash value of a life insurance policy: Interest rate charges are generally less than for personal or credit card loans.
J. Tapping into a company savings plan.
K. Using after-tax money from a Roth IRA: Tap into money that can be taken out without penalty or tax consequences.

3. Savings strategies

A. Goal setting: Goals should be realistic and agreed upon by the family.
B. Self-rewarding plan: If a family exceeds the savings goal, they should spend the extra savings on themselves.
C. Savings-first approach: Save first and pay cash to avoid high interest charges on loans and to earn interest by investing the savings. Automatic savings plan. Deduct directly from a paycheck and invest the funds in savings. This includes dollar cost averaging into mutual funds and contributions to company retirement plans.

4. Emergency fund planning

A. Adequacy of reserves—Three to six months of monthly expenses is typically a reasonable range. For one-income families, a six-month level may be more appropriate. For two-income families, a three-month level may be adequate.

B. Liquidity versus marketability

(1) Marketability: The ease with which an asset may be bought or sold.
(2) Liquidity: The ease with which assets can be converted into cash with little risk of loss of principal. Real estate is considered illiquid because it may take a while to sell and the asking price may be lowered. However, real estate is marketable because it is relatively easy to sell a house if priced below market value.
(3) Liquidity substitutes: Checking and savings accounts, money market accounts, U.S. Treasury bills, certificates of deposit (CDs), cash value of a life insurance policy, company savings plan, and home equity loans.

5. Debt management ratios

A. The client should have sufficient liquid assets for an emergency fund (generally three to six months of fixed and variable outflows).
B. Rule of thumb: Consumer debt, such as credit cards, auto loans, and the like, should not exceed 20 percent of net income (gross income – taxes).
C. Rule of thumb: Monthly payments on a home (including principal, interest, taxes, and insurance) should be no more than 28 percent of the owner’s gross income. This is known as the housing payment ratio.

D. Rule of thumb: Total monthly payment on all debts should be no more than 36 to 38 percent of gross monthly income (principal, interest, taxes, insurance [PITI], credit payments, alimony, child support, and maintenance). This is known as the total payment ratio. Renter's expenses divided by gross income = 30 percent.

E. Preferably more than one source of income. If there is only one source of income, greater planning is required. Having many sources of income creates greater financial stability. Savings and investments of at least 5 to 10 percent of gross income, not including reinvested dividends and income, are recommended.

(1) Consumer debt

(a) Types of consumer debt: (1) 30-day or regular charge accounts; (2) revolving and optional charge accounts; (3) installment purchases or time-payment plans.

(b) Two methods: (1) buying on time from the seller or (2) borrowing money from credit institution, usually in the form of credit cards.

(c) Sources of consumer credit—commercial banks, consumer finance companies, credit unions, savings and loan associations, life insurance companies (cash value), brokerage companies (margin), and auto dealers (auto financing).

(2) Housing costs

(a) Home equity loan and home equity line of credit: A home equity loan is cash that is given up front (interest charged from start) at a fixed interest rate. In contrast, a home equity credit line allows the individual to use the money only when needed (no interest charged until used), but at a variable rate that is usually tied to the prime rate. Keep the current first mortgage and get a second loan for the necessary cash amount. If current mortgage rates are higher than that of the existing first mortgage, a home equity loan will allow the borrower to keep the current low first mortgage rate. Interest is fully tax deductible on home equity loans up to $100,000.

(3) Total debt

TOPIC 6: FINANCING STRATEGIES

1. Long-term versus short-term debt

A. Certain debts that cannot be discharged in Chapter 7 can be discharged in Chapter 13. Chapter 13 is often preferable to Chapter 7 because it enables the debtor to keep a valuable asset, such as a house.

2. Secured versus unsecured debt

A. Property of the estate: Property that is not exempt; property of the estate is usually sold by the trustee, and the claims of creditors are paid from the proceeds.

B. Qualified retirement plans: The Supreme Court held that retirement plans that have a legally enforceable anti-alienation clause (a provision preventing creditors from attacking the retirement funds of a debtor) are not property of the estate and thus are not subject to the jurisdiction of the bankruptcy court and cannot be accessed to pay creditors. Nearly all pensions and 401(k) savings plans that are qualified under Employee Retirement Income Security Act (ERISA), the federal pension savings act, have an anti-alienation clause that excludes them from the bankruptcy estate. An exception to this rule is retirement plans that have only one participant, such as single employee corporate plans, and some other plans originating in self-employment.

C. Tax-advantaged saving plans: When retirement savings are property of the estate, because they are not ERISA qualified or because they are held in an IRA, they may be exempted from the estate under the available exemption statutes. Property that is exempt is removed from the estate and is not liable for the payment of creditor claims. The exact scope of the exemption and how much value can be exempted depends on the language of the exemption selected under state law.

D. Exemptions: Exemptions are the lists of the kinds and values of property that are legally beyond the reach of creditors or the bankruptcy trustee. Exemptions constitute the one area in which bankruptcy law varies from state to state. Congress created a set of exemptions in the Bankruptcy Code but allowed each state to opt out of those exemptions in favor of the state exemptions. Sixteen states allow debtors to elect the Bankruptcy Code exemptions. In those states, debtors have a choice between the federal exemptions and those in the law of their state. For the rest of the states, only the state exemptions can be selected.

E. Dischargeable versus nondischargeable: A discharge releases the debtor from personal liability for discharged debts and prevents the creditors owed those debts from taking any action against the debtor or his or her property to collect the debts. Most unsecured debt is dischargeable. Most secured debt (liens and mortgages) survives bankruptcy as a charge on the property to which it attaches unless a court order modifies the lien. The following debts cannot be discharged in either Chapter 7 or Chapter 13. If you file for Chapter 7, you will still be responsible for repaying these debts after your discharge. If you file for Chapter 13, these debts will have to be paid in full in your plan. If they are not, the balance will remain at the end of your case: debts you forget to list in your bankruptcy papers, unless the creditor learns of your bankruptcy case; child support; alimony; debts for personal injury or death caused by driving while intoxicated; student loans, unless it would be an undue hardship for you to repay fines and penalties for violating the law, including traffic tickets and criminal restitution; recent income tax debts (past three years) and all other tax debts; certain long-term obligations (such as a home mortgage). The following debts may be declared nondischargeable by a bankruptcy judge in Chapter 7 if the creditor challenges your request to discharge them: debts you incurred on the basis of fraud; credit purchases of $1,150 or more for luxury goods or services made within 60 days of filing; loans or cash advances of $1,150 or more taken within 60 days of filing; debts resulting from willful or malicious injury to another person or another person's property; debts arising from embezzlement, larceny, or breach of trust; debts you owe under a divorce decree or settlement, unless after bankruptcy you would still not be able to afford to pay them or the benefit you would receive by the discharge outweighs any detriment to your ex-spouse (who would have to pay them if you discharge them in bankruptcy). Alternatives—debt consolidation, debt negotiation, and home equity loans or line of credit.

3. Consumer protection laws

A. Federal Trade Commission (FTC): The Commission has enforcement and administrative responsibilities under 46 laws. Statutes relate to competition and consumer protection missions.

B. Consumer protection mission of the FTC

(1) Truth in Lending Act: Title I of the Consumer Credit Protection Act requires all creditors who deal with consumers to make certain written disclosures concerning all finance charges and related aspects of credit transactions (including disclosing finance charges expressed as an annual percentage rate).
(2) Fair Credit Billing Act: This amendment to the Truth in Lending Act protects the borrower in the event a credit card is lost or stolen to a maximum loss of $50 per card or until the card has been reported as missing if less; prohibits creditors from taking actions that adversely affect the consumer's credit standing until an investigation is completed.
(3) Equal Credit Opportunity Act: Title VII of the Consumer Credit Protection Act prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or good faith exercise of any rights under the Consumer Credit Protection Act. The Act also requires creditors to provide applicants, upon request, with the reasons underlying decisions to deny credit.

4. Buy versus lease/rent

A. Buying or leasing an automobile

(1) To buy: For business use, taxpayers who own an auto can choose the standard mileage rate in the first year and switch to actual expense method in a later year if it becomes more favorable. Taxpayers who lease an auto can choose the standard mileage rate in the first year, but must use it for the life of the auto. Consumer intends to keep the auto for more than four years. Auto is driven for more than 15,000 miles per year. Lease contracts generally have a 15,000 limit and charge for excess miles. Consumer has cash for the purchase or down payment.
(2) To lease: Lower monthly payments with little or no down payment. This leaves more cash to invest elsewhere, such as business or investments. Leasing is suited for individuals who desire a new car every two or three years and who would borrow to pay for a new car. The trade-in value would be less than the loan value, resulting in a loss.
(3) Service, convenience, and flexibility: Taxpayer needs or desires a high-priced vehicle for business use. Tax advantages of leasing over buying increase with a car's value and percentage of business use.
(4) Off-balance-sheet financing for business: For business use, taxpayers who trade in autos every three years or less usually end up with a realized loss that cannot be deducted. The taxpayer's basis (after limited depreciation deductions) exceeds the trade-in value, but the loss is not recognized, because of Section 1031 like-kind exchange rules. For business use, the cost of interest is included in the lease payments (the entire payment is 100 percent deductible). Interest is not deductible for employees who purchase their vehicles.

B. Buying a house or leasing (renting)

(1) The most common reason for renting instead of buying is the lack of funds for a down payment; buying a home offers many advantages: There are tax advantages with home ownership; creditors look more favorably on homeowners; a residence's monthly housing costs tend to be more stable than the cost of renting; renting may make sense if the stay is short term.
(2) Adjustable and fixed rate loans: Fixed rate loans have a stated interest rate that lasts for the term of the loan and are more appropriate for clients with a low tolerance for risk.

Adjustable rate loans have provisions that permit the lender to change the interest rate periodically. If the time expected to be in a house is short term, an adjustable rate mortgage (ARM) may be preferred to a fixed rate mortgage because of lower initial interest rates resulting in the lowest current payment. This assumes the client has a higher risk tolerance for a variable rate. An ARM with a 2/6 cap indicates a 2 percent maximum interest rate increase per year, 6 percent life of loan. In a low or increasing interest rate environment, a client is best served using a fixed rate loan. In contrast, in a high or decreasing interest rate environment, the client may be best served with a variable rate loan.

C. Effect on financial statements

(1) Balance sheet effect: Leased or rented assets have no entry except to the extent that a lump sum may have been taken from one of the listed assets as an initial payment to secure the leased asset. An initial payment results in a cash decrease and a decrease in net worth. There is no debt, so there is no asset. Purchased assets with 100 percent cash—reduce cash but add in the asset by the same amount—result in no change to net worth. Purchased assets with loan—result in a reduction of cash or other liquid asset that was used for the purchase or down payment. If there is a loan that was secured in order to purchase the asset, it will show up as a liability. This results in no change to net worth. For example, assume $5,000 cash is used as a down payment to purchase a car valued at $10,000, and the remaining $5,000 is financed through an auto loan. The effect is a $5,000 increase in assets ($10,000 market value of car minus $5,000 decrease in cash) and a $5,000 increase in liabilities (loan amount).

5. Mortgage financing

A. Conventional versus adjustable-rate mortgage (ARM)
B. Home equity loan and line of credit
C. Refinancing cost-benefit analysis
D. Reverse mortgage

TOPIC 7: FUNCTION, PURPOSE, AND REGULATION OF FINANCIAL INSTITUTIONS

1. Banks

A. Primary depository for checking accounts and short-term financing for corporations; insured by the Federal Deposit Insurance Corporation (FDIC).

2. Credit unions

A. Primary depository for checking accounts and short-term financing for corporations; nonprofit, cooperative financial institutions owned and run by members; members pool their funds to make loans to one another. The members elect the volunteer board that runs each credit union. Depositors benefit from earnings—in the form of dividends—after operating expenses are paid and reserve requirements are satisfied. Credit unions are organized to serve people in a particular community, group or groups of employees, military, or members of an organization or association. They are insured by the National Credit Union Administration (NCUA), an agency of the United States government, for losses up to $100,000.

3. **Brokerage companies**
   A. Primary depositories for investment accounts that trade stocks. The distinction between brokerage firms and banks has become blurred; however, the Glass-Steagall Act of 1933 forbids banks from underwriting corporate securities. Insured by the Securities Investor Protection Corporation (SIPC) up to $500,000.
4. **Insurance companies**
   A. Primary places for obtaining life, health, property, and disability insurance. In the McCarran-Ferguson Act, Congress reaffirmed the right of the federal government to regulate insurance, but agreed it would not exercise this right as long as the industry was adequately regulated by the states. In effect, the law explicitly grants the states the power to regulate the insurance business. The National Association of Insurance Commissioners (NAIC) is composed of the commissioners of insurance from all states. It has no legal power over insurance regulation, but the Commissioner of Insurance in each state is charged with the administration of the state's insurance laws and operations and recommends legislation.
5. **Mutual fund companies**
   A. Primarily start open-end and closed-end mutual funds and sell these to the investing public, but some offer other services like the sale of stocks and bonds; insured by the SIPC.
6. **Trust companies**
   A. Savings and loans: Primarily a source for mortgage loans; insured by the FDIC. FDIC reimburses the depositor for any losses up to $250,000; a depositor does not have to be a U.S. citizen or even a resident of the United States. Protects deposits that are payable in the United States. Deposits payable only overseas are not protected. All types of deposits received by a financial institution in its usual course of business are insured. FDIC does not insure Treasury securities. Deposits in different institutions are insured separately. If an individual deposits at the main office and at one or more branch offices of the same institution, the deposits are added together in calculating deposit insurance coverage. Deposits maintained in different categories of legal ownership are separately insured. A depositor can have more than $250,000 insurance coverage in a single institution. Joint accounts are insured separately from single-ownership accounts. IRA and Keogh funds are separately insured from any nonretirement funds the depositor may have at an institution. If a depositor has both a Roth IRA and a traditional IRA at an insured depository institution, the funds in those accounts would be added together. The new limit for IRA FDIC insurance is $250,000. SIPC protects customers of broker-dealers as long as the broker-dealer is an SIPC member. If an SIPC member's registration with the U.S. Securities and Exchange Commission is terminated, the broker-dealer's SIPC membership is also automatically terminated. Brokerage firms that are members of the SIPC pay the cost of insurance. Customers of a failed brokerage firm get back all securities (such as stocks and bonds) that already are registered in their names or are in the process of being registered. If sufficient funds are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $100,000 for cash claims. Among the investments that are ineligible for SIPC protection are commodity futures contracts and currency, as well as investment contracts (such as limited partnerships) that are not registered with the U.S. Securities and Exchange Commission under the Securities Act of 1933.

TOPIC 8: EDUCATION PLANNING

1. Funding

A. Hope Credit: Available only for first two years of undergraduate work; qualified expenses include tuition (books and supplies are included as qualified tuition only if the fees must be paid to the institution as a condition of enrollment). Expenses that do not qualify include room and board and, generally, books and supplies. The amount of credit is 100 percent of the first $1,200 of qualified tuition you paid for each eligible student and 50 percent of the next $1,200. The maximum amount is $1,800 times the number of eligible students. See supplement for phaseout restrictions.

B. Lifetime Learning Credit: Available for all years of undergraduate and graduate work; qualified expenses include tuition (books and supplies are included as qualified tuition only if the fees must be paid to the institution as a condition of enrollment). Expenses that do not qualify include room and board and, generally, books and supplies. The amount of the credit is 20 percent of the first $10,000 of qualified tuition paid for all eligible students. The maximum amount per family is $2,000 and is calculated as 20 percent × $10,000. See supplement for phaseout restrictions.

2. Needs analysis

A. The goal is to establish a saving schedule for the client; it requires the following: the age at which the child will attend college, the after-tax earnings rate of the parents, the inflation-adjusted interest rate, the current cost of tuition, and the rate of increase—the rate of increase is generally the rate of inflation but can differ.

B. For example, consider the following hypothetical: John Harris wants to plan for his son's education. His son was born today and will attend a private university for four years beginning at age 18. Tuition is currently $20,000 a year and increases annually at 7 percent, whereas inflation increases only at 3 percent per year. John expects to earn an after-tax return of 10 percent from investments. How much must John save at the end of each year if he would like to make his last payment at the beginning of his son's first year of college? Solving this problem requires three steps: (1) Inflate the current cost of tuition by the tuition inflation rate for the number of years until the child begins college. Calculator: 20,000 [PV]; 18 [N]; 7 [I]; 0 [PMT] = −67,598 [FV]. (2) Calculate the present value of an annuity due for the number of years the child will attend college. Use the inflation-adjusted discount rate for this step. Calculator: begin mode; 67,598 [PMT]; 0 [FV]; 4 [N]; 1.10 [ENTER] 1.07 [÷] 1 [−] 100 [×][I] = −259,530[PV]. Determine the periodic payment that must be made to reach the account balance in step 2. Calculator: end mode; 259,530 [FV]; 18 [N]; 10 [I]; 0 [PV] = 5,691[PMT].

3. Tax credits/adjustments/deductions

A. Student loan interest: Taxpayers can deduct up to $2,500 of interest on qualified education loans for college expenses as an adjustment to income. The deduction phases out when modified adjusted gross income (AGI) exceeds certain limits. Voluntary payments of interest are also deductible. Deductible amounts must be reduced by any nontaxable education benefits received, such as employer-provided assistance and nontaxable distributions from a Coverdell education savings account (ESA). The deduction cannot be claimed in a year in which a Hope Credit or Lifetime Learning Credit has been claimed for the same student. See supplement for phaseout restrictions.

4. Funding strategies

A. Section 2503(c) Minor's Trust: Allows the transferred trust property to be treated as a gift of a present interest to the child and so qualifies for the annual gift tax exclusion; the trust is used when (1) the grantor's income tax bracket is high and the recipient's tax bracket is low and (2) the grantor does not want an appreciating asset included in the gross estate. If income of the trust is distributed each year, it is taxable to the recipient (who is usually at a lower tax bracket); if income is accumulated, it is taxed to the trust. All of the trust property and accumulated income must be payable to the child when he or she reaches age 21.

5. Ownership of assets

A. Affects financial aid: When determining how much a family can afford to pay, the processing firm uses the federal methodology formula known as the expected family contribution. To pay for college, parents can use as much as 47 percent of after-tax income, but no more than 5.6 percent of assets—capital gains are treated as income. The amount of total contribution expected from a family is reduced by saving money in the parent's name and not the child's name—the formula calls on students to contribute 35 percent of their assets to college costs. Investing in a 401(k) or other tax-sheltered retirement plans is excluded in calculating total value of assets owned by parents.

6. Vehicles

A. Qualified tuition programs (§529 plans)

(1) Qualified tuition plans (QTPs or 529 plans); every state's program must meet the regulations of Section 529 of the Internal Revenue Code defining QTPs. It is a state-sponsored, taxed advantage plan used for undergraduate- and graduate-level expenses; extends tax-exempt status to qualified tuition programs funded by private institutions. Account owner selects beneficiary.

(2) If beneficiary does not attend college, the contributor is allowed to replace the current designated beneficiary with a new beneficiary who is a member of the family. The plan can be established by anyone to pay for qualified education expenses. Tax-free growth of earnings if withdrawn for qualified educational expenses. Penalty-free withdrawals include tuition, room and board, and books and supplies. The funding is treated as a gift of a present interest qualifying for the annual $13,000/$26,000 tax exclusion. Contributor may elect to treat the gift as occurring ratably over a five-year period, so that the $13,000/$26,000 exclusion can be leveraged to as much as $65,000/$130,000 in one year. Contributions are treated as a completed gift for estate and gift tax purposes. This rule applies despite the fact that the owner retains ownership rights, which would normally be treated as his or her estate.

(3) While it varies by state, there is generally no age restriction for the beneficiary. Contributions can be made to a Coverdell (education) IRA and a 529 College Savings Plan in the same year for the same beneficiary without penalty. Contributions may be deductible for state income tax (depending on state plan). Contribution limits vary by state, but some plans allow an annual contribution of up to $318,000.

(4) Investment choices—vary by type of plan:

(a) Prepaid tuition plan: Guarantees money saved today matches the growth in tuition inflation at state-run colleges; college savings plan. Managed by state treasurer or outside investment adviser—invests in stocks, bonds, and cash. Impact of financial

aid—varies by type of plan: Prepaid tuition plan. Every dollar used for tuition takes a dollar away from the student's eligibility for aid.
(b) College savings plan: If plan is in parent's name, the college will count no more than 5.6 percent of the money each year. If the plan is in the child's name, each year the school may want 25 or 30 percent of the money.
(c) Coordination with Hope and Lifetime Learning Credits: Can claim the Hope and Lifetime Learning Credit in the same year of receiving a tax-free distribution provided the distribution is not used for the same expenses for which the credit is claimed.

(5) Major drawbacks:

(a) This is a long-term plan that should be started when the child is 10 years old or younger. Withdrawals are treated as income to the child and could hurt financial aid. Typically they provide very few investment choices; they are difficult to transfer to another program earnings taxed as ordinary income and a 10 percent penalty tax on nonqualified distributions.
(b) They may impact financial aid: Consider coordination of Hope and Lifetime Learning Credits.
(c) Can claim the Hope and Lifetime Learning Credit in the same year of receiving a tax-free distribution from a Coverdell ESA or 529 Plan provided the distribution is not used for the same expenses for which the credit is claimed; the contribution is phased out if AGI exceeds limits (unlike a 529 Plan).

(6) Savings bonds or CDs: Savings bonds sold at a discount and pay no annual interest; interest earned is not taxable at the state and local levels, but is taxable at the federal level. Interest is excluded from federal income tax if used for higher-education expenses in the same calendar year the bonds are redeemed.

(a) The following criteria must also be satisfied: A person has to be at least 24 years old at time of issuance; registered in name of purchaser or child if intended for child's education; only savings bonds issued after December 21, 1989; qualified educational expenses include tuition and fees; the cost of books and room and board are not qualified expenses; the exclusion is phased out with high AGI. The exclusion is not available for married taxpayers filing separately.

(7) CollegeSure CD: Sold in whole units and fractional units and is purchased from College Savings Bank; do not have to buy CollegeSure CDs in one lump sum; calculates the annual interest on a CD on the basis of the Independent College 500 Index; there is no limit on how much a CD can earn—the CD is guaranteed to keep up with college costs. The CD is guaranteed to earn a minimum of 4 percent even if college costs do not increase in a given year. Insured by FDIC for up to $100,000, and investors pay no fees or commissions. If student earns a scholarship, the parents get back all the money they have invested plus the accumulated interest.

B. Coverdell Education Savings Accounts

(1) Education IRAs (also called Coverdell ESAs): An education savings plan used for undergraduate- and graduate-level expenses

(a) Account owner selects beneficiary: Parent or guardian establishes the account and can elect to maintain control over the account for educational purposes (the institution where you establish the Coverdell ESA will have policies determining the decision-making authority for the account). Any withdrawals from the Coverdell

ESA are paid to the beneficiary and are not refunded to the parent or other person who establishes the account. If beneficiary does not attend college, the beneficiary can be changed to a member of the beneficiary's family if under the age of 30. To establish the account, beneficiary must be under age 18 unless the individual is designated as a special needs beneficiary. Tax-free growth of earnings occurs if withdrawn for qualified educational expenses before the child is age 30. Withdrawals are tax-free if they are not more than the beneficiary's qualified education expenses for the tax year.

(b) Contributions can be made only after the beneficiary reaches age 18 if the beneficiary is a special needs beneficiary; can be made to one or several Coverdell ESAs for the same designated beneficiary, provided that the total contributions are not more than the contribution limit; can be made to a Coverdell ESA and a 529 College Savings Plan in the same year for the same beneficiary without penalty; nondeductible from taxes; penalty-free withdrawals are tuition, room and board, and books and supplies. Earnings are taxed as ordinary income and subject to 10 percent penalty for nonqualified use. Parent or guardian manages the investment choices, and there is a broad choice of investment vehicles, including stocks and bonds.

(2) Uniform Transfers to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) accounts

(a) Two vehicles are designed to set up custodial accounts in a child's name for the benefit of the child; simple and inexpensive method of making a gift to a child without the expense of a trust; parents often transfer assets to children to reduce the income taxes on the earnings (taxed to the child's bracket). Money transferred to a custodial account is considered an irrevocable gift. Once the child reaches the age stipulated by law—usually 18 or 21—the money is the child's to use as he or she pleases. No guarantee is required that the child will use the money for college. Ownership of assets has implications for college financial aid. In calculating estimated family contributions toward college costs, the standard federal aid formula requires children to pay 35 percent of savings held in their names. In contrast, parents contribute only 5.6 percent of their assets.

(3) Savings bonds

(4) Zero coupon bonds: Promise no interest during the life of the bonds but only the payment of the principal at maturity—the bonds are sold at a discount. A tax feature reduces the attractiveness of zero coupon bonds. The IRS taxes the accrued interest even though the investor does not receive the funds until a bond matures.

7. Financial aid

A. Government grants and loans; grants and scholarships; Pell Grants; distributed on the basis of financial need—maximum amount is up to $3,750 per year. These are available only to undergraduate students, both part-time and full-time (reduced grants for part-time students). Federal Supplemental Education Opportunity Grants (FSEOGs): Distributed on the basis of financial need—maximum amount is up to $4,000 per year; available to undergraduate students only, both part-time and full-time (reduced grants for part-time students). Students receiving Pell Grants are given highest priority.

B. Student loans

C. Perkins Loan: Funded by the federal government, but administered by the individual schools. Distributed on the basis of financial need—maximum amount is $4,000 per year for undergraduate students and $6,000 per year for graduate students. Available to graduate and undergraduate students, both part-time and full-time. Five percent interest, and allows for a grace period of nine months after graduation before loan payments are due. Repayment is usually over 10 years.

D. Stafford Loans: Available to graduates and undergraduates, both part time and full time. Based on financial need, with limits applying as to the amount of funds that may be received, both in any one year and cumulatively. Interest rate fluctuates with the 91-day T-bill plus 3.1 percent, capped at 9 percent for the first four years of repayment.

E. Subsidized loans (needs based): Students will not be charged any interest before they begin repayment or during authorized periods of deferment.

F. Unsubsidized loans: Repayment begins at loan inception. Eligible students are provided employment to earn maximum amounts stated by the federal government while attending school.

TOPIC 9: FINANCIAL PLANNING FOR SPECIAL CIRCUMSTANCES

1. Divorce

A. Property valuation and settlement

(1) It is important to understand that *equitable* does not mean “equal”; it only means “fair.”

(2) Property settlements—Section 1041—no gain or loss on divorce transactions

B. Career assets

(1) Sometimes one spouse has significant assets tied to his or her career. For example: A wife quits her job so her husband can move and advance his career.

(2) Career assets include life, health, disability, and long-term care insurance; vacation and sick pay; Social Security; stock options; and pension and retirement plans.

(3) Career assets are assumed to be jointly owned by both spouses.

C. Family business and house

(1) Three options for when deciding how to divide a business and/or house:

(a) One spouse keeps the business/home by buying out the other’s interest.

(b) Both spouses continue to own business/home.

(c) The business/home is sold and proceeds are divided.

D. Retirement plans. Two methods for dividing:

(1) Buy-out or cash-out method: Nonemployee spouse gets a lump sum settlement—or marital asset of equal value—at the time of divorce in return for the employee’s right to keep the retirement plan.

(2) Deferred division or future value method: No present value is determined—each spouse gets an equal share of the benefits when they are paid.

E. Alimony

(1) A series of payments from one spouse to another, or to a third party on behalf of the receiving spouse

(2) Taxable income to the recipient and, generally, tax-deductible expense to the payer

F. Child support

(1) Established by the courts and based on the ratio of each parent's income, the percentage of time the child spends with each parent, and the amount of alimony payments made to the custodial parent
(2) Is not deductible by the payor and not includible in the income of the recipient
(3) The child can be counted as an exemption by only one parent, but the exemption can be traded back and forth each year.
(4) Only the custodial parent is entitled to claim both the child and the dependent care credit.

2. Disability

A. The chance of becoming disabled prior to retirement is greater than the chance of death. Purchasing a disability income policy satisfies full protection.
B. Workers' compensation handles work-related injuries.
C. Company sickness and accident plans have waiting periods and are limited to years of coverage.

3. Terminal illness

A. Long-term care insurance: Insurance policy used to provide funding for long-term care, such as stays in nursing homes, not covered under Medicare or other medical expense policies. Viatical agreements. Terminally ill individuals may be able to sell their life insurance policies to a viatical company.

4. Nontraditional families

A. Proper estate planning through wills and trust is essential—there is no unlimited marital deduction for unmarried couples. Planning is necessary for single parents, as well as ensuring necessary amounts of insurance inasmuch as there is only one wage earner.

5. Job change and job loss

A. Emergency fund covering three to six months of expenses. State unemployment insurance programs exist in all states and are designed to provide protection against involuntary unemployment when the individual is available for work but is temporarily unemployed. Protection is limited in amount and duration. Payable through state unemployment offices. Unemployment compensation is taxable and reported by a taxpayer on Form 1099-G.

6. Dependents with special needs

A. The special needs are typically those that help support and educate a child with serious physical, emotional, and/or cognitive problems. Special needs trusts can preserve state-provided benefits that would be prohibitively expensive otherwise.

7. Monetary windfalls

A. A client who receives an immediate lump sum of money. Great care should be displayed when approaching clients who never have had such a large sum of money and whose desire is to spend it immediately.
B. An analysis of receiving the lump sum versus taking a periodic annuity should be conducted.

TOPIC 10: ECONOMIC CONCEPTS

1. Supply and demand

A. Demand curve

(1) The law of demand states that higher prices reduce the demand for an item and lower prices increase the demand for an item.
(2) Consumers buy less of a product as prices increase primarily because of the availability of substitutes.

(a) A substitute is an item that performs functions similar to those of an item it has replaced.
(b) Consumers are more responsive to price when more viable substitutes are available.

(3) The demand curve slopes down to the right, indicating that as price drops, the quantity demanded will increase—indirect relationship.
(4) Price elasticity is manifested when a small price change causes a rather large change in the amount purchased.

(a) This is common with goods that have many substitutes. For example, if the price of Pepsi rises, consumers will purchase Coke.
(b) Perfect elasticity results in a horizontal demand curve.
(c) Time has the greatest effect on elasticity; when the price of a product increases, consumers will reduce their consumption more in the long run than in the short run—called the second law of demand.

(5) Price inelasticity is manifested when a large price change does not cause much change in the quantity demanded.

(a) Inelastic goods have few substitutes. An example of an inelastic good is gasoline. Even as the price rises, people still need to buy gasoline.
(b) Perfect inelasticity is represented by a demand curve that is vertical.

(6) Movement along the demand curve represents a change in quantity demanded resulting from a price change. However, some factors will cause a shift in demand. A shift in demand is caused by:

(a) Changes in consumer income
(b) Changes in the price of related goods (substitutes and complements). If two goods go together, they are complements—for example, ice cream and hot fudge. A price rise in one good will cause a drop in demand for its complement.
(c) Changes in consumer expectations
(d) Changes in the number of consumers in the market
(e) Demographic changes
(f) Changes in consumer tastes and preferences

B. Supply curve

(1) The law of supply indicates that a higher price will increase the supply of a good.
(2) There is a direct relationship between the price of a good and the amount supplied in the marketplace.
(3) The supply curve is elastic when a price change leads to a large change in quantity supplied. This happens when resources are added inexpensively. The supply curve is inelastic when a price change leads to a small change in supply.

(4) Change in quantity supplied is identified as movement along the supply curve. It is the willingness of producers to offer a good at different prices. A shift in the entire supply curve is referred to as a change in supply.

(5) Factors that increase the opportunity cost of producing a good will discourage production and shift the supply curve inward to the left; the reverse is also true. Such factors include the following:

(a) Changes in resource prices. Higher resource prices (and opportunity costs) will reduce the supply of a good, causing a shift to the left in the supply curve.

(b) Changes in technology. Lower-cost techniques will increase production and decrease the opportunity cost of a good, causing the supply curve to shift outward to the right.

(c) Natural disasters and political disruptions

C. Income elasticity is the sensitivity of demand to change in consumer income.

(1) An inferior good has negative income elasticity. This means that when income increases, the quantity demanded decreases; when income decreases, the quantity demanded increases. An example of an inferior good is margarine.

(2) A normal good has positive income elasticity. When income increases (decreases), the quantity demanded also increases (decreases). An example of a normal good is butter.

2. Fiscal policy

A. Fiscal policy refers to the government's ability to influence the economy by raising or lowering government spending and taxes.

B. If the government wants to stimulate the economy, it can implement expansionary fiscal policy by increasing spending or reducing taxes. This generally results in increased gross domestic product (GDP) and higher price levels.

C. The government can use restrictive fiscal policy to slow the economy by decreasing spending and increasing taxes.

Fiscal Policy Summary

Fiscal policy deals with the following three items: taxes, public spending, and government borrowing.

Expansionary	**Contractionary**
Taxes go down.	Taxes go up.
Public spending goes up.	Public spending goes down.
Government borrowing goes up.	Government borrowing goes down.

3. Monetary policy

A. Monetary policy is used by the Federal Reserve System (Fed) to influence the money supply.

B. The Federal Reserve controls the money supply with three policy tools:

(1) The required reserve ratio. Required reserves are the minimum reserves banks must hold as required by law. These funds do not earn interest and cannot be lent to customers. When the required reserve ratio falls, the money stock rises. However, the money supply increases only if member banks are willing to lend and their customers are willing to borrow. This is an uncommon choice by the Fed.

(2) Open market operations: This is the Fed's most powerful tool for controlling the money supply. If the Fed sells government securities, it receives money in return, which reduces the money supply. If the Fed buys government securities, it adds reserves into the banking system and the money supply grows.

(3) Discount rate: The discount rate is the rate charged to member banks when they borrow from the Fed. If the discount rate drops, member banks can borrow at a lower cost to meet reserve requirements. Therefore, banks are more willing to provide loans to consumers because they can borrow from the Fed at a lower rate in case of emergency. The result is an increase in the money supply when the discount rate drops. However, this is overestimated in the public's eyes because most of the borrowing and lending of reserves takes place in the federal funds market, rather than through direct borrowing from the Fed. The federal funds market is where banks borrow reserves from other banks. The rate of interest charged is called the federal funds rate. As a result, the discount rate has little impact on the money supply.

C. The Fed can participate in expansionary or restrictive policy.

  (1) Expansionary policy is manifested when the Fed increases the money supply by lowering the required reserve ratio, buying government securities, or lowering the discount rate.

  (2) Restrictive policy is manifested in a reduction in the growth rate of the money supply caused by raising the required reserve ratio, selling government securities, or raising the discount rate.

D. In the short run, an unanticipated increase in the supply of money will increase aggregate demand.

E. If the increase in money supply is anticipated, there will be little or no impact on aggregate demand or real interest rates. In addition, an anticipated change in the money supply has the same effects as long-run implications of monetary policy.

F. Supply of money

  (1) M-1, the simplest definition of the supply of money, includes currency in circulation (coins and paper), checkable deposits, and traveler's checks.

  (2) M-2, a broader definition, equals M-1 plus savings deposits and time deposits less than $100,000 plus money market mutual fund shares.

  (3) If individuals shift from savings accounts to checking accounts, the money supply is increased under the narrow definition (M-1) but is unaffected under the broader definition (M-2).

G. The impact of monetary policy of stock prices

  (1) The effects of monetary policy are shown via the dividend-discount model:

    (a) $V = D_0(1 + g)/k - g$

    (b) Where V is the value of the stock, D_0 is the dividend that is currently being paid, k is the investor's required rate of return, and g is the growth rate in the firm's dividend.

    (c) Any factor that affects any variable of the model then must have an impact on the valuation of the stock.

  (2) When the Federal Reserve tightens credit and drains the money out of the system, interest rates rise.

(a) Higher interest rates increase the required rate of return (k) and suggest that the value of the stock should decline.

(b) Higher interest rates may also reduce the firm's earnings, hurting its ability to grow and pay dividends; the D_0 or g is reduced, causing the value of the stock to decline.

(3) The easing of credit has the opposite effect.

(a) Lower interest rates may increase the value of a stock by increasing earnings.

(b) This leads to higher dividends or increased growth, and a lower required rate of return (k).

(4) The anticipation of higher interest rates suggests that investors should avoid fixed income investments, firms whose cost of funds is sensitive to changes in interest rates and unable to pass on the increased cost, and firms in cyclical industries whose product demand is affected by changes in interest rates.

Monetary Policy Summary

Monetary policy deals with the following three items:

- **Legal reserve**—Increase contracts the money supply.
- **Discount rate**—Increase discourages banks from lending money, because it makes it more expensive to borrow.
- **Open market operations—**Federal Reserve buys securities (i.e., Treasuries), which stimulates growth by putting more money into the marketplace.

4. Economic indicators

A. Investors who invest on the basis of relationships between security prices and economic activity want to know the direction of economic change before it happens. An emphasis is placed on leading economic indicators of economic activity.

B. The National Bureau of Economic Research (NBER) tabulates a series of economic indicators. The 10 leading indicators are:

(1) Stock prices (S&P 500 index)
(2) Average weekly work hours
(3) Average unemployment claims
(4) Manufacturers' new consumer goods orders
(5) Manufacturers' new orders for nondefense capital goods
(6) Vendor performance (companies receiving slower deliveries)
(7) New building permits
(8) Interest rate spread (difference between 10-year Treasury bond and federal funds rate)
(9) Inflation-adjusted M-2
(10) Consumer expectations from the University of Michigan Research Center

C. Measures of inflation can have an important impact on investor behavior.

(1) Inflation is a general rise in prices and is measured by an index.
(2) Two commonly used indexes are the Consumer Price Index (CPI) and the Producer Price Index (PPI).

(a) CPI is calculated by the Bureau of Labor Statistics and measures the cost of a basket of goods and services over time.
(b) PPI is calculated by the U.S. Department of Labor and measures wholesale cost of goods over a period of time.

5. **Business cycles**

A. The term *business cycle* refers to a pattern of changing economic output and growth. The business cycle starts at an initial period of growth and rises as the economy expands until it reaches a peak. The economy then declines, reaching a trough, and subsequently starts to rebound to repeat the process.
B. The peak is generally accompanied by an increased rate of inflation. This results in a period of rising unemployment and declining national output, called a recession.
C. A recession is a period when real GDP declines for two or more successive quarters; a depression is a prolonged and very severe recession.
D. Gross domestic product (GDP) is the most common means of measuring economic activity.

(1) GDP is the total value of all final goods and services newly produced within a country by domestic factors of production.
(2) Trucks made in the United States by Honda are included in GDP, whereas IBM computers made in Europe are not.

E. The key variables used for determining the phase of the business cycle are real GDP and the unemployment rate. Real GDP is nominal GDP that has been adjusted to remove the impact of inflation. The average expansion lasts 3.5 years, while the average contraction lasts 1 year.

Business Cycle Summary

For the exam, you need to understand the cause-and-effect relationship. Remember, businesses adapt more quickly to changes in the economy than consumers do.

Midcontraction–Midtrough

Interest rates go down.
Inflation goes down.
Stocks go up.
Bonds go up.
Real estate goes down.
Gold goes down.
Physical assets go down.

Midtrough–Midexpansion

Interest rates go down.
Inflation goes down.
Unemployment goes down.
Capacity utilization goes up.
Capital spending goes up.
Bond purchases go up.
Corporate earnings go up.
Stocks go up.

(*Continued*)

(*Continued*)

Midexpansion–Midpeak

Interest rates go up.
Inflation goes up.
Labor productivity goes up.
Capacity utilization goes up.
Fed tightens up—money supply goes down.
Hard assets go up.
Real estate goes up.
Gold goes up.

Midpeak–Midcontraction

Interest rates go up.
Inflation goes up.
Profits go down.
Capital spending goes down.
Unemployment goes up.
Stocks go down.

6. Inflation, deflation, and stagflation

A. Definitions

(1) *Inflation* is manifested when prices are rising, when it costs more one year to buy the same goods and services as it did the year before.
(2) *Deflation* is manifested when prices are falling.
(3) *Disinflation* is manifested when the rate of inflation decreases; prices are still rising, but at a slower pace.
(4) *Recession* is a period of rising unemployment (which may or may not be accompanied by deflation)—real GDP declines for two or more successive quarters.

B. Inflation

(1) In a period of inflation, investors should avoid interest-sensitive securities and long-term debt instruments that pay fixed amounts of interest.
(2) They should acquire short-term instruments (U.S. Treasury bills) whose yields will increase with the rate of inflation.
(3) The expectations of an inflationary environment suggest that investors should stress common stocks of firms whose asset bases will be enhanced by increased asset values (oil, metal, and land companies). Investors should avoid stocks of firms lacking assets that would rise with inflation.

C. Deflation

(1) In periods of deflation, prices of tangible assets (real estate, collectibles, and precious metals) will decline.
(2) The anticipation of deflation strongly suggests that investors should acquire those financial assets whose values will not fall.

(3) The safest strategy is to acquire short-term liquid assets, such as bank deposits, because deflation will increase the purchasing power of money.
(4) Deflation makes long-term debt obligations good investments, but an investor should purchase only bonds of excellent quality, because deflation may be accompanied by bankruptcies as firms are unable to meet their financial obligations.
(5) The same stress on quality applies to common stocks. Because many firms will experience falling demand and declining profit margins, quality should be stressed in purchasing stocks.

D. Recession and economic stagnation

(1) During a recession, the Federal Reserve will put money into circulation and expand the supply of credit. This expansion will at least initially decrease interest rates until the stimulus increases the level of economic activity.
(2) The federal government will adopt an expansionary fiscal policy. Lower taxes and increased government expenditures will increase aggregate demand for goods and services. This increased demand is designed to stimulate economic activity, which reduces the level of unemployment.
(3) To take advantage of the economic stimulus, the investor will seek to move out of short-term money market instruments into common stocks of firms that will benefit from the expansionary monetary and fiscal policy.
(4) Once the investor identifies the firms most likely to benefit from the expansionary monetary and fiscal policy, he or she may adopt any of a number of individual strategies:

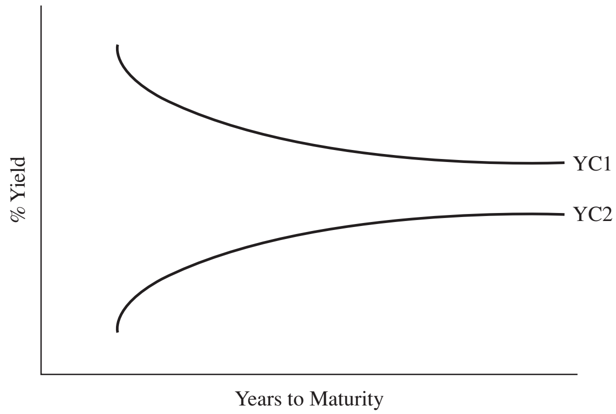
(a) A conservative strategy may include the purchase of convertible securities (i.e., convertible bonds and preferred stock) and common stocks of firms with low beta coefficients. Fixed-income securities may be purchased in anticipation of lower interest rates. But the investor must be willing to move rapidly out of fixed-income securities, because they do not benefit from economic expansion and may be hurt if the expansion leads to higher interest rates.
(b) An aggressive strategy designed to take advantage of expansionary fiscal policy will stress less current income (i.e., no fixed-income securities) and more potential for capital gains. The investor will then primarily purchase common stocks of firms with low payout ratios that retain earnings to finance expansion.

7. Yield curve

A. A graph showing the relationship between term to maturity and yield to maturity is known as a yield curve.
B. The yield curve shows the relationship between interest rates and time, typically relating to government Treasury securities.
C. The yield curve is important to investors because as rates change, they usually do not change by the same amount of basis points across maturities.
D. Yield curve risk is the risk that yields for different maturities may not change by the same amount in the presence of an interest rate change.

(1) The risk is measured with the help of duration—a measure of bond price sensitivity to interest rates.

Question: Consider the yield curves depicted. Assume yield curve 1 (YC1) changed to yield curve 2 (YC2) over a period of time.



Which of the following provide information that can be interpreted from these yield curves?

I. The Fed's monetary policy eased between YC1 and YC2.
II. Reinvestment rate risk decreased between YC1 and YC2.
III. Long-term bonds purchased at YC1 increased in price.
IV. The economy is moving from a bear market to a bull market.

A. I and IV only
B. II and III only
C. II and IV only
D. I, III, and IV only*
E. II, III, and IV only

TOPIC 11: TIME VALUE OF MONEY CONCEPTS AND CALCULATIONS

1. **Present value**

   A. Present value is determined by taking the future value of a sum of money and calculating what it is worth today, using a discount rate. The formula is $PV = FV/(1 + I)^N$.

   (1) *Example:* Calculate the present value of $10,000 to be received in five years, using an annual interest rate of 10 percent.
   (2) *Solution:* 10,000 FV, 10 I, 5 N, calculate PV → $6,209.21.

   B. The more frequent the compounding, the smaller the present value.

2. **Future value (FV)**

   A. Future value (FV) is the future amount of a sum invested today that will grow over time when it is compounding interest. The formula for finding the future value of a single cash flow is FV = PV(1 + I)N.

   (1) *Example:* Calculate the future value of $10,000 invested for five years, using an annual interest rate of 10 percent.
   (2) *Solution:* −10,000 PV, 10 I, 5 N, calculate FV. $16,105.10.

3. **Ordinary annuity and annuity due**

   A. An annuity is a series of equal cash flows that occur at equal intervals over a period of time. For example, the receipt of $1,000 at the end of each year for the next 10 years is an annuity.

(1) An ordinary annuity is one in which cash flows begin at the end of each year.
(2) An annuity due is one in which cash flows begin on the same day as the initial investment.

B. *Example* 1: Finding the future value of an ordinary annuity.

(1) Calculate the future value of an ordinary annuity that will pay $1,000 per year for each of the next 10 years while earning a 12 percent rate of return.
(2) *Solution:* 10 N, 12 I, 1,000 PMT, compute (CPT) FV. $17,548.73.

C. *Example* 2: Finding the present value of an annuity due.

(1) Calculate the present value of an annuity of $2,000 received annually, beginning today and continuing for 15 years, earning a 10 percent rate of return.
(2) First, put your calculator in the begin mode.
(3) *Solution:* 15 N, 10 I, 2,000 payment (PMT), CPT PV. $16,733.38.

D. *Example* 3: Finding the annual payment in an ordinary annuity.

(1) Calculate the annual payments required to fund your retirement plan in order to have $25,000 at the end of 10 years while earning a 12 percent rate of return.
(2) *Solution:* 10 N, 12 I, FV 25,000, CPT PMT. $1,424.61.

E. *Example* 4: Finding the monthly payment in an annuity due.

(1) Calculate the annual payments received at the beginning of each month for 10 years from an investment of $50,000 earning an annual return of 7 percent, compounded monthly.
(2) First, put your calculator in the begin mode.
(3) *Solution:* 120 N (10 × 12), .5833 (7/12) I, −50,000 PV, CPT PMT. $577.17.

4. Net present value (NPV)

A. Net present value is the amount of cash flow (in present value terms) that a project generates after repaying the invested capital and required rate of return on that capital.
B. If the project generates a positive NPV, then shareholder wealth increases. In contrast, a negative NPV will decrease shareholder wealth.
C. NPV is considered better than internal rate of return (IRR) because it measures profitability in dollars added to shareholder value. In contrast, IRR measures profitability as a rate of return.
D. NPV assumes that the reinvestment rate of cash flows is the cost of capital, whereas IRR assumes that the reinvestment rate is the IRR.
E. When the IRR is equal to the cost of capital, the NPV will be zero. If the IRR is less than the cost of capital, the result is a negative NPV.
F. *Example:* Calculate the NPV of a project with an initial cost of $2,000 that produces the following cash flows (CF): year (1) +1,000; year (2) +500; year (3) +700; year (4) −500; year (5) +300. The cost of capital is 5 percent.
(*Solution:* −2,000[CF0]; 1,000 CFj; 500 CFj; 700 [CFj]; 2,500 [CFj]; 300 [CFj]; 5 [I]; [NPV] −$165.71.)

5. Internal rate of return (IRR)

A. The IRR calculates the rate of return at which the present value of a series of cash inflows will equal the present value of the project's cost.

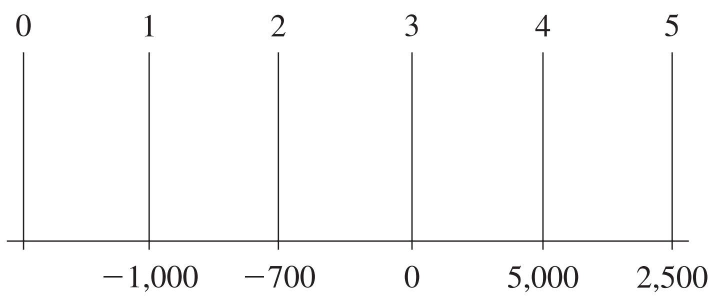
B. It is also defined as the rate of return in which the net present value of a project is zero. It assumes that all cash flows are reinvested at the IRR.
C. The IRR is equivalent to the yield to maturity (YTM), the geometric average return, and the compounded average rate of return.
D. If IRR is less than the cost of capital, reject the project. If IRR is greater than the cost of capital, accept the project.
E. *Example:* Calculate the IRR of a project that has an initial outflow of 5,000 and will generate the following cash flows: year (1) 3,000; year (2) −500; year (3) 2,500; year (4) 500; year (5) 1,500.

   Solution: −5,000[CF0]; 3,000 CFj; −500 CFj; 2,500 [CFj]; 500 [CFj]; 1,500 [CFj]; [IRR] 14.09 percent.

6. Uneven cash flow

A. It is common for the stream of cash flows to change from year to year for projects or investments, so it is not an annuity. The uneven cash flow is simply just a stream of (annual) single cash flows.
B. To determine the FV/PV of irregular cash flows, you need to find the FV/PV of each cash flow and then add them up. The PV of an uneven cash flow stream is also calculated using the NPV function on your calculator.
C. *Example* 1: Calculate the present value of an uneven cash flow series using a 10 percent discount rate and PV1 through PV5. Assume cash flows are:

Exhibit 1.1 Cash Flow Diagram



PV_1: enter FV =	−1,000; I/Y	= 10; N = 1; CPT → PV_1 =	−909.09
PV_2: enter FV =	−700; I/Y	= 10; N = 2; CPT → PV_2 =	−578.51
PV_3: enter FV =	0; I/Y	= 10; N = 3; CPT → PV_3 =	0.00
PV_4: enter FV =	5,000; I/Y	= 10; N = 4; CPT → PV_4 =	3,415.07
PV_5: enter FV =	2,500; I/Y	= 10; N = 5; CPT → PV_5 =	1,552.30
	Add up the PVs		3,479.77

7. Serial payments

A. A serial payment is a payment that increases at some constant rate on an annual basis; the constant rate is usually inflation.
B. The last serial payment will have the same purchasing power as the initial serial payment.

C. Serial payments are not fixed payments like annuities; the first serial payment will be less than an annuity payment, but the last serial payment will be more than an annuity payment.
D. *Example* 1: Assume Jeff wants to start a business in five years. He needs to have $250,000 (today's dollars) in five years to finance his business. Inflation is expected to average 3 percent, and Jeff can earn an 8 percent annual compounded rate on his investments. What serial payment should Jeff invest at the end of the first year?
Solution: 250,000 FV; 5 N; 0 PV; [(1.08/1.03 − 1)] × 100[I]; [PMT] 1.03 [×]$46,736.78

Question: An individual takes out a $150,000 mortgage at 7 percent interest for 15 years. Assuming he decides to pay the mortgage back at the beginning of year (2), what would be the outstanding principal balance at the beginning of year (2)?

A. $133,531
B. $139,500
C. $144,031*
D. $145,108

TOPIC 12: FINANCIAL SERVICES REGULATIONS AND REQUIREMENTS

1. **Registration and licensing**

A. Financial Industry Regulatory Authority (FINRA; formerly the NASD)

(1) Anyone who sells stocks, bonds, tax-sheltered investments, options, mutual funds, or other securities must register with the FINRA in addition to the Securities and Exchange Commission (SEC).
(2) The FINRA is an independent group overseen by the SEC and is a self-governing organization that polices its own members.
(3) Registration with the FINRA is accomplished by completing a Uniform Application for Securities Industry Registration, a Form U-4, and receiving a passing grade on one or more exams, depending on the products the adviser wishes to sell. Passing the exam(s) and being given the right to sell makes the individual a registered representative (Registered Representative).
(4) Qualification and registration requirements for security licenses:

(a) Series 3—Futures and Commodities. For individuals who wish to sell commodities or futures contracts
(b) Series 4—Registered Options Principal. For managers supervising options sales personnel or supervising compliance
(c) Series 6—Investment Companies. For individuals who wish to sell only mutual funds and variable annuities
(d) Series 7—General Securities Representative. For individuals who wish to trade securities
(e) Series 9 and 10 (also known as Series 8)—General Sales Supervisor. For New York Stock Exchange (NYSE) managers to supervise branch activities
(f) Series 11—Assistant Representative. For sales assistants who wish to accept unsolicited customer orders

(g) Series 24—General Securities Principal. For licensing NYSE managers to supervise branch activities
(h) Series 27—General Financial/Operations Principal. Required for the chief financial officer of FINRA member firms
(i) Series 55—Registered Equity Trader. Required for persons participating in equity trading
(j) Series 63—Uniform State Law. Required for most individuals who solicit orders for any type of security in a particular state
(k) Series 65—Registered Investment Adviser. Required by many states for individuals who act as investment advisers
(l) Series 66—Combined Registered Investment Adviser/Uniform State Law. Combines the Series 65 and Series 63 licenses

B. The insurance buyer makes contact with the insurer in any of three ways and must be registered as such.

(1) Agent: Representative of the insurance company (also called principal). An agent has authority to act on behalf of the principal in business transactions and has the power to bind a company to a risk by acceptance.
(2) Broker: A marketing intermediary between the insurer and the policy owner, who represents the policy owner instead of the insurer. This generally permits sales representatives to sell products from a number of companies, primarily as the representative of the insurance buyer. In regard to insurance consultants and financial planners, many states require anyone who presents him- or herself as providing advice regarding insurance, including financial planners, to have a license.
(3) Service representatives: These are salaried individuals hired by insurers to assist agents in selling and servicing insurance. A license is usually not required by the state to act as a service representative.

C. SEC Release No. IA-770: The SEC has taken the position that the Investment Advisers Act of 1940 is the statutory body of law that should control the area of regulation of financial planners.

(1) SEC Release No. IA-770 sets forth three separate tests for determining whether a financial planner's activities fall under the Investment Advisers Act of 1940. All three tests must be answered in the affirmative for the Investment Advisers Act of 1940 to apply to the financial planner.
(2) Investment advice is clearly a part of the person's primary business. The advice is specific and action oriented. The adviser receives compensation for the advice.
(3) If a financial adviser passes all of these tests, the SEC assumes that he or she is in the business of investment advice and requires that person to register unless otherwise exempted.

D. The Investment Advisers Act of 1940 specifies six areas set forth in Section 202(a)(11) that eliminate the need for financial service professionals to be subject to the mandates of the statute. The Investment Advisers Act of 1940 does not apply to any of their activities if they fall within the following categories:

(1) Any bank or holding company that is not an investment company
(2) Any lawyer, accountant, engineer, or teacher, when the advisory services are "solely incidental" to the practice of his or her profession

(3) Any broker, dealer, or registered representative whose performance of advisory services is solely incidental to his or her performance as a broker or dealer and who receives no specific compensation for these services
(4) The publishers of newspapers, newsmagazines, or business or financial publications of general or regular circulation
(5) Any person whose advice, analysis, or reports relate only to securities that are direct obligations of or publications guaranteed as to principal or interest by the United States of America
(6) Any other persons not within the intent of law as specified by the SEC

E. There are five other groups of individuals who fall within the definition of investment adviser but are exempt from registration with the SEC under Section 203(b) of the Investment Advisers Act of 1940:

(1) Any investment adviser whose clients are all residents of the state in which the adviser maintains his or her principal office and place of business and who does not provide advice or analysis in regard to listed securities or on any securities admitted to unlisted trading privileges on any national securities exchange
(2) Any investment adviser whose primary clients are insurance companies
(3) Any investment adviser who has fewer than 15 clients in a year and does not present him- or herself as an investment adviser to the public
(4) Any investment adviser that is a charitable organization or employed by a charitable organization and provides advice and analysis only to charitable organizations
(5) Any investment adviser who provides investment advice exclusively to church employee pension plans

F. Investment Advisers Supervision Coordination Act of 1996—enacted in 1997, the Investment Advisers Supervision Coordination Act of 1996 changed the landscape in regard to the Investment Advisers Act of 1940. The primary outcome is that financial planners need to be registered with the SEC or state authorities, but not both.

(1) Any adviser with $30 million or more of assets under control will still have to register with the SEC, but will be exempt from state registration.
(2) Those with less than $30 million in managed assets will have to register with the state. Any adviser with between $25 million and $30 million of managed assets can register with either the state or the SEC.
(3) All other areas of the Investment Advisers Act of 1940, with the exclusion of registration, will still apply to Registered Investment Advisers (RIAs).
(4) States retain jurisdiction in regard to fraud and illegal activity as it applies to RIAs.
(5) A national de minimis standard rule was introduced, stating that investment advisers may not be required to register in a state unless the adviser has a place of business in that state or, during the preceding 12 months, has had more than five clients who are residents of the state.
(6) Record-keeping rules put forth that no state may require more stringent requirements than the resident state of the adviser.
(7) The Act allows the denial of registration to felons if within 10 years of the conviction.
(8) The Act mandated a new consumer information hotline allowing for inquiry regarding disciplinary actions and proceedings against any RIA or associates.

2. Reporting

A. Form ADV

(1) When an investment adviser is required to register with the SEC, he or she must also file SEC Form ADV and pay the required filing fees. Form ADV contains two sections:

(a) Part I contains general and background information regarding the applicant and questions regarding the applicant's expected clients.
(b) Part II is more detailed, requiring information about the adviser's fee structure, specific types of services offered, and the method of business operation, as well as questions in regard to the direct involvement of the adviser in securities transactions for his or her clients.

(2) Once registration is complete, the investment adviser may use the official title of Registered Investment Adviser, but not the initials "RIA," which may suggest that an exam or class work was completed and a professional designation obtained.
(3) Form ADV generally restricts advisers from "performance-based" fees in regard to the performance of assets under management; however, there is no restriction placed on the adviser in basing fees as a percentage of the total assets under management with a client. Rule 205-3 says performance-based fees are permitted when (1) the client is a registered investment company, (2) the adviser manages more than $750,000 of the client's assets, or (3) the adviser believes that the client's net worth exceeds $1.5 million.

B. Brochure rule

(1) Since January 1979, RIAs are required to deliver a written disclosure, a requirement commonly called the "brochure rule." The disclosure is to be delivered to the client within 48 hours of entering into an investment advisory agreement or when the contract is signed if the client has the right to terminate the contract within five days of signing.
(2) Form ADV, Part II, can be used to meet the requirement of the brochure rule.

3. Compliance

A. The SEC requires a detailed file of record keeping.
B. Section 206 of the Investment Advisers Act of 1940 has also come to be known as the "antifraud provision," making any illegal actions by the adviser equivalent to fraud. The Act puts the adviser in a fiduciary position.
C. Should an adviser fail to meet any of the requirements of the Investment Advisers Act of 1940, the registration process, or the continued registration requirements, the SEC may investigate and confiscate all books and records as well as levy fines for noncompliance.
D. The Insider Trading and Securities Fraud Enforcement Act of 1988 mandates that investment advisers maintain a clearly written set of rules and policies in order to prevent the likelihood of insider trading on nonpublic information.

4. State securities and insurance laws

A. State securities

(1) Advisers should be knowledgeable of the "blue sky laws" mandated by states requiring the registration of advisers.
(2) Currently, 49 states require the registration of investment advisers.
(3) Many states require a minimum capitalization amount as a prerequisite for granting investment adviser registration.

B. Insurance laws

(1) In contrast to securities, the insurance industry is regulated at the state level. Advisers wishing to sell insurance products must be licensed for all products they wish to sell within the state in which they work. This means that advisers wishing to sell all types of insurance must pass exams for each type as specified by each state.
(2) Keep in mind that variable life and variable annuities contain investments and, therefore, require the adviser to also have a Series 6 securities license.

TOPIC 13: BUSINESS LAW

1. Contracts

A. Definitions important to contract law include:

(1) Offeree: Person to whom an offer is made
(2) Offeror: Person who makes an offer

B. Legal requirements for contracts—for a valid contract to exist, five elements must exist: offer and acceptance, genuine assent, adequate consideration, capacity, and legality.

(1) Offer and acceptance: One party must make a definite, unqualified offer, and the other party must accept this offer in total. Three conditions must exist for this to be a valid offer: intent, communication, and definiteness. Three conditions must exist for this to be a valid acceptance: bilateral contract or a unilateral contract, content, and communication.
(2) Genuineness of assent: It is important that both parties are bound by their promises. There are certain conditions that would cause a lack of assent so that no valid contract exists:

(a) Misrepresentation
(b) Duress, indicating a condition of coercion
(c) Undue influence, indicating a lack of assent by the offeree
(d) A unilateral mistake, whereby one party knows or should realize that the other party is relying on a mistaken belief or incorrect information
(e) A mutual mistake, indicating a contract that contains latent ambiguities and can be avoided by either the offeror or the offeree
(f) A lack of mutuality exists in a situation in which a statement has been made that sounds like a promise but does not, in reality, bind the person making the statement to do anything.

(3) Adequate consideration: Consideration is something that is bargained for and exchanged in a contract.
(4) Legal capacity: The parties to an enforceable contract must be capable of entering into the contract in the eyes of the law. There are certain parties who lack legal capacity: A minor lacks legal capacity; an insane person lacks legal capacity; an intoxicated person may lack legal capacity.
(5) Legality: The terms of a contract cannot require any laws to be broken.

C. Types of contracts

(1) Nature of the promise

(a) Bilateral contract: The promise of one party is exchanged for the promise of the other party. Both parties make promises that are legally enforceable.

(b) Unilateral contract: The promise of one party is exchanged for the other party's performing some act or refraining from some act. Only one party can be forced to comply with the contract. For example, insurance contracts are unilateral. Only the insurer is legally bound to do something. The insured makes no promise to do anything. Of course, if the insured does not pay the renewal premium, the policy is canceled.

(2) Legal validity and enforceability

(a) Enforceable contract: All conditions and elements are present and clear.
(b) Void contract: A void contract has no legal standing because it lacks one or more of the requirements specified by law for a valid contract.
(c) Voidable contract: A voidable contract is a legally enforceable contract, but one from which at least one of the parties can escape liability because of lack of capacity, lack of mutuality, duress, misrepresentation, undue influence, or mistake.
(d) Quasi-contract: Not actually a contract, but can act like one. It serves as a remedy where someone has unjustly received a benefit but where there was no contract.
(e) Unenforceable contract: A contract can exist because it has all of the elements of a valid contract. However, at least one of the parties may have a defense that can be used to render it unenforceable, such as the Statute of Frauds or a material breach of contract.

D. Two topics in contract law, which are unrelated to each other, concern written agreements:

(1) The Statute of Frauds states in general that a contract does not have to be in writing in order to be enforceable. However, there are exceptions to this general rule. The following contracts must be in writing to be enforceable:

(a) A promise to answer for debts of another. For example, one person promises to pay a debt and another person guarantees that promise. The guarantee must be in writing to be enforceable.
(b) A contract to transfer an interest in real estate must be in writing.
(c) A contract that cannot, by its terms, be performed within one year from the date of agreement must be in writing.
(d) The Uniform Commercial Code (UCC) on the sale of goods of $500 or more must be in writing.

(2) The parol evidence rule also impacts written contracts. When a contract is in writing, this rule limits the evidence that can be introduced at trial to prove what the terms of the contract are. The contract as written will be binding on both parties.

E. Any nonperformance of a contract is a breach of the contract. However, there are times when nonperformance of the terms of a contract is excused:

(1) If one party has committed a material breach, the other party is excused from performance.
(2) Death excuses a party from the duty to perform services, but not from the contractual duty to deliver goods or convey real estate.
(3) If a breach of contract has occurred, there are various remedies available to the nonbreaching party. The nonbreaching party can be awarded monetary damages.

(a) The general measure of monetary damages is the amount of money that will put the nonbreaching party in the position that he or she would have occupied had there been no breach. Such damages are known as compensatory damages.
(b) Punitive damages are damages aimed at punishing the breaching party rather than merely compensating the nonbreaching party. Punitive damages are not usually allowed in breach-of-contract cases.
(c) Liquidated damages are damages for breach of contract where the monetary amount was agreed to at the time the contract was made. Courts allow such damages only if the amount is reasonable.
(d) Under certain circumstances, the nonbreaching party can be awarded equity.

2. Torts

A. A person can commit two classes of wrongs: public and private.

(1) A public wrong is a violation of one of the laws that govern the relationships of the individual with the rest of society. It is called a crime and is subject to criminal law.
(2) A private wrong is an infringement of the rights of another individual. A private wrong is called a tort, and the person who commits such a wrong is called a tortfeasor. A tort may give the person whose rights were violated a right of action for damages against the tortfeasor. This action is called a civil action.

B. Torts are divided into two types: intentional and unintentional.

(1) Intentional torts include infringements on the rights of others such as assault and battery, libel, slander, false arrest or imprisonment, trespass, and invasion of privacy. Individuals who suffer injury as a result of these intentional torts have the right to sue for damages.
(2) Unintentional torts are those that result from negligence or carelessness, and in these cases, the injured party may also be entitled to damages in a civil action even though the tortfeasor had no malicious intent as in an intentional tort.

C. An individual's exposure to financial loss associated with liability may arise from three sources: (1) criminal acts, (2) torts, and (3) legal liability arising out of breach of contract.
D. Liability insurance is rarely concerned with the legal penalties resulting from criminal behavior or intentional torts. In liability insurance, we are concerned primarily with unintentional torts or losses arising from negligence.

3. Agency

A. The term agency refers to a two-party relationship in which one party (an agent) is authorized to act on behalf of the other (a principal).
B. Certain general characteristics are found in this type of relationship:

(1) In acting for a principal, the agent has a fiduciary duty to act for the benefit of the principal and not in the agent's own self-interest.
(2) The agent may be subject to the control of the principal.

(a) If the agent is an independent contractor, the principal has no control.
(b) If the agent is an employee of the principal, the agent is subject to the control of the principal.

C. The principal will be bound by an agent's contracts made with third parties as long as the agent has one of the following kinds of authority:

(1) Implied authority: The authority that an agent has as necessary to carry out acts needed to exercise his or her express authority.
(2) Apparent authority: Authority that, in the absence of contrary action by the principal, appears to a reasonable person to be possessed by the principal's agent.

D. A principal is liable for all torts committed by its agents in the scope of employment.
E. An agent will have liability to a third party for the agent's own torts and contracts.

(1) An agent is liable along with the principal for the agent's own torts.
(2) For contracts, the general rule is that the principal is liable and the agent is not, as long as the agent acted within the scope of the agent's authority and the identity of the principal was fully disclosed. This rule holds regardless of how authority arose.

F. The relationship between a principal and an agent can be terminated. The relationship can be terminated by operation of law. The following automatically terminate an agency:

(1) Death of either the principal or the agent
(2) Insanity of either the principal or the agent
(3) Bankruptcy of the principal
(4) Illegality of agency purpose

4. Negotiable instruments

A. A negotiable instrument is a written contract that can be used as a substitute for money. In negotiable instruments: Generally, there are two types of negotiable instruments:

(1) A promissory note is a written promise to make payment.
(2) A draft is a written order to make payment, but three parties are involved. Even if a single party occupies two of these positions, it is still a three-party instrument.

B. A holder in due course of a negotiable instrument is entitled to payment despite most defenses that the maker or drawer may have. There are several exceptions to the rule that a holder in due course takes the negotiable instrument free of personal defenses:

(1) Infancy is a defense against a holder in due course. Thus, a minor who signs a promissory note cannot be held liable.
(2) An exception arises if the instrument was created under extreme duress.
(3) An exception arises in case of bankruptcy of the party designated to make payment.
(4) An exception arises if a fraud occurred that the signer of the instrument had no opportunity to detect.

C. Several steps are necessary for a party to become a holder in due course of a negotiable instrument:

(1) A document is considered a negotiable instrument only if it has a particular form.

(a) It must be in writing and signed by the maker or drawer.
(b) It must contain an unconditional promise or order to pay.
(c) It must be for a sum certain in money.
(d) It must be payable at a definite time or on demand.

(e) It must be payable to the order of a party or payable to the bearer of the instrument (except for checks).
(f) It must contain no other obligation, promise, or requirements.

(2) The person trying to assert status as a holder in due course of the instrument must be a holder. The person is a holder if the instrument was properly negotiated to him or her.

D. The relationship that exists between a bank and its customers is also important. The bank (the drawee on a check) has an obligation to a customer (the drawer of a check). A bank must also follow a customer's order not to pay:

(1) An oral stop order is valid for 14 days.
(2) A written stop order is valid for six months.

E. A person who presents an instrument for payment and a person who transfers an instrument to another party make, by operation of law, certain warranties regarding the instrument. The warranties in these two cases differ slightly, but, in general, they are as follows:

(1) The person has good title to the instrument that is being presented or transferred.
(2) All signatures are genuine or authorized.
(3) There are no known defenses to the instrument.

5. Fiduciary liability

A. Because of the nature of a practitioner-client relationship, services and recommendations provided by financial planning practitioners carry a certain level of liability exposure; it is inherent to the profession. The Practice Standards, however, should assist the practitioner in managing that risk. The potential of common-law liability to clients includes liability based on (1) breach of contract, (2) tort or negligence, and (3) fraud.

TOPIC 14: CONSUMER PROTECTION LAWS

1. Bankruptcy

A. Chapter 7 of the United States Bankruptcy Code is the Bankruptcy Code's "liquidation" chapter. To qualify for relief under Chapter 7 of the Bankruptcy Code, the debtor must be an individual, a partnership, or a corporation. As of October 2005, debtors have to satisfy a "means test," which determines whether they have an appropriate income level for the repayment of the debt. The individual debtor is permitted to retain certain "exempt" property. A trustee liquidates the debtor's remaining assets. Accordingly, potential debtors should realize that the filing of a petition under Chapter 7 may result in the loss of property. The discharge has the effect of extinguishing the debtor's personal liability on dischargeable debts. A discharge is available to individual debtors only, not to partnerships or corporations.

B. Chapter 11 bankruptcy

(1) Reorganizations of persons, firms, and corporations, especially those whose debts exceed the limits of Chapter 13. The court ultimately approves (confirms) or disapproves the plan of reorganization. The debtor usually remains in possession of his or her assets and continues to operate any business, subject to the oversight of the court and the creditors' committee.

C. Chapter 13 bankruptcy

(1) For debtors who are in financial difficulty and who voluntarily petition the bankruptcy court. The debtor receives a briefing 180 days before that individual can proceed with Chapter 13 bankruptcy. Furthermore, after the bankruptcy filing, the debtor must complete a financial management instructional course before being discharged. The debtor keeps his or her property and makes regular payments to the Chapter 13 trustees out of future income to pay creditors over time (three to five years). An individual debtor faced with a threatened foreclosure of the mortgage on his or her principal residence can prevent an immediate foreclosure by filing a Chapter 13 petition. Certain debts that cannot be discharged in Chapter 7 may be discharged in Chapter 13. Chapter 13 is often preferable to Chapter 7 because it enables the debtor to keep a valuable asset, such as a house.

2. Property of the estate

A. Property that is not exempt; property of the estate is usually sold by the trustee, and the claims of creditors are paid from the proceeds.

3. Qualified retirement plans

A. The Supreme Court held that retirement plans that have a legally enforceable anti-alienation clause (a provision preventing creditors from attacking the retirement funds of a debtor) are not property of the estate and thus are not subject to the jurisdiction of the bankruptcy court and cannot be accessed to pay creditors.

B. Nearly all pensions and 401(k) savings plans that are qualified under Employee Retirement Income Security Act (ERISA), the federal pension savings act, have an anti-alienation clause that excludes them from the bankruptcy estate. An exception to this rule is retirement plans that have only one participant, such as single employee corporate plans, and some other plans originating in self-employment.

4. Tax-advantaged saving plans

A. When retirement savings are property of the estate, because they are not ERISA qualified or because they are held in an IRA, they may be exempted from the estate under the available exemption statutes.

B. Property that is exempt is removed from the estate and is not liable for the payment of creditor claims. The exact scope of the exemption and how much value can be exempted depends on the language of the exemption selected under state law.

5. Exemptions

A. Exemptions are the lists of the kinds and values of property that are legally beyond the reach of creditors or the bankruptcy trustee. Exemptions constitute the one area in which bankruptcy law varies from state to state.

B. Congress created a set of exemptions in the Bankruptcy Code but allowed each state to opt out of those exemptions in favor of the state exemptions. Sixteen states allow debtors to elect the Bankruptcy Code exemptions. In those states, debtors have a choice between the federal exemptions and those in the law of their state. For the rest of the states, only the state exemptions can be selected. Dischargeable versus nondischargeable: A discharge releases the debtor from personal liability for discharged debts and prevents the creditors owed those debts from taking any action against the debtor or his or her property to collect the debts.

C. Most unsecured debt is dischargeable. Most secured debt (liens and mortgages) survives bankruptcy as a charge on the property to which it attaches unless a court order modifies the lien.
D. Qualified plans, 529 accounts (where contributions are made prior to one year before filing for bankruptcy), and the first $1 million of an IRA are exempt in all states. Loans from retirement plans are not treated as bankruptcy debts.
E. The following debts cannot be discharged in either Chapter 7 or Chapter 13. If you file for Chapter 7, you will still be responsible for repaying these debts after your discharge. If you file for Chapter 13, these debts will have to be paid in full in your plan. If they are not, the balance will remain at the end of your case:

    (1) Debts you forget to list in your bankruptcy papers, unless the creditor learns of your bankruptcy case
    (2) Child support
    (3) Alimony
    (4) Debts for personal injury or death caused by driving while intoxicated
    (5) Student loans, unless it would be an undue hardship for you to repay fines and penalties for violating the law, including traffic tickets and criminal restitution
    (6) Recent income tax debts (past three years) and all other tax debts
    (7) Certain long-term obligations (such as a home mortgage)

F. The following debts may be declared nondischargeable by a bankruptcy judge in Chapter 7 if the creditor challenges your request to discharge them:

    (1) Debts you incurred on the basis of fraud
    (2) Credit purchases of $1,150 or more for luxury goods or services made within 60 days of filing
    (3) Loans or cash advances of $1,150 or more taken within 60 days of filing
    (4) Debts resulting from willful or malicious injury to another person or another person's property; debts arising from embezzlement, larceny, or breach of trust; debts you owe under a divorce decree or settlement, unless after bankruptcy you would still not be able to afford to pay them or the benefit you would receive by the discharge outweighs any detriment to your ex-spouse (who would have to pay them if you discharge them in bankruptcy)
    (5) Alternatives—debt consolidation, debt negotiation, and home equity loans or line-of-credit consumer protection laws

G. Federal Trade Commission (FTC): The Commission has enforcement and administrative responsibilities under 46 laws. Statutes relate to competition and consumer protection missions.
H. Consumer protection mission of the FTC:

    (1) Truth in Lending Act
    (2) Title I of the Consumer Credit Protection Act requires all creditors who deal with consumers to make certain written disclosures concerning all finance charges and related aspects of credit transactions (including disclosing finance charges expressed as an annual percentage rate).

I. Fair credit reporting law

    (1) Amendment to the Truth in Lending Act

        (a) Protects the borrower in the event a credit card is lost or stolen to a maximum loss of $50 per card or until the card has been reported as missing if less; prohibits creditors from taking actions that adversely affect the consumer's credit standing until an investigation is completed. The maximum amount that may be garnished from wages is 25 percent of take-home pay.

(2) Equal Credit Opportunity Act
(3) Title VII of the Consumer Credit Protection Act

(a) The Act prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance, or good faith exercise of any rights under the Consumer Credit Protection Act. The Act also requires creditors to provide applicants, upon request, with the reasons underlying decisions to deny credit.

J. Privacy policies

(1) Identity theft protection

(a) The Identity Theft and Assumption Deterrence Act of 1998 outlawed identity theft and made it a crime subject to a maximum penalty of $250,000.

Question: Which debt can be discharged under a Chapter 7 bankruptcy?

A. Student loan
B. Mortgage loan*
C. Alimony
D. Child support

Question: Which property can be exempt from Chapter 7 bankruptcy proceedings?

I. Home equity—specific limited amount
II. Life insurance
III. Car equity—specific limited amount
IV. Personal property—specific limited amount

A. I and III only
B. I, II, and IV only
C. III and IV only
D. I, II, III, IV*

Question: The Consumer Credit Protection Act provides all the following protections EXCEPT:

A. Three-day right of recission against borrower's home if used as collateral
B. Lost credit card limit of $50
C. Fifty percent of take-home pay as the maximum garnishment for unpaid debts*
D. Disclosure of credit life insurance cost

MULTIPLE-CHOICE QUESTIONS

1. ***Practice—financial planning process* (CFP® Exam, released 1/99). You receive a phone call from an individual you have not spoken with previously. The caller is excited, just having heard that a new mutual fund is positioned to deliver larger gains in the coming year. The caller wishes to purchase shares of the fund through you. Keeping in mind stages of the**

overall personal planning process, which of the following questions that address the first two stages of the financial planning process should you ask the caller?

(1) What are your goals for this investment?
(2) What other investments do you have?
(3) What is your date of birth?
(4) Do you want your dividends reinvested?

A. 1 and 2 only
B. 2 and 4 only
C. 1, 2, and 3 only
D. 1, 2, and 4 only

Ans. C

2. ***Practice—financial planning process.* Which one of the following statements regarding the second step of the process, Gathering client data and determining goals and expectations, is correct?**

A. General goals, such as "adequate retirement income" provide appropriate guidance in developing the plan.
B. Quantitative information and qualitative information are equally important.
C. This step provides the greatest time-saving potential since most of the information required can be estimated and reasonable accuracy is not affected.
D. Most clients will be able to completely implement their financial plans in a relatively short period of time, so prioritization is merely a formality and not particularly important.

Ans. B

3. ***Practice—financial planning process*. What is the first step in the financial planning process?**

A. Recommending a plan
B. Establishing the client planner relationship
C. Analyzing information
D. Gathering data

Ans. B

4. ***Practice—ethics.* A client of a CFP is seeking advice regarding the tax consequences of an investment. The CFP meets with the client and gets the information about the investment, but has his assistant calculate the tax consequences and write a letter to the client. Which of the following is true?**

A. The letter should have been signed by the CFP.
B. It would be okay if the assistant were a CPA.
C. The CFP should not consult on tax consequences of investments.
D. The CFP is ultimately responsible.

Ans. D

5. ***Practice—ethics*. The following are Code of Ethics' Principles EXCEPT:**

A. Integrity
B. Competence

C. Professionalism
D. Consistency

Ans. D

6. ***Practice—ethics.*** **Your client's old CPA put him into an oil and gas partnership that lost him money. Although he doesn't feel the CPA necessarily misled him, he wants to know what he can do to seek reimbursement.**

A. Tell him there is no recourse.
B. Tell him he can consult an attorney.
C. Call the CPA.
D. Notify the CPA Board.
E. Do nothing.

Ans. B

7. ***Practice—ethics.*** **Under what circumstances can a CFP reveal client confidential information?**

(1) To defend oneself against an action of wrongdoing
(2) To demonstrate the type of work performed
(3) To complete a new account form
(4) To convey data to an estate planning attorney with the implied consent of the client

A. 1 only
B. 1 and 2
C. 3 and 4
D. 1, 2, and 4

Ans. D

8. ***Practice—ethics.*** **After working with your client, he advises you that he didn't disclose all assets as part of a prenuptial agreement. You have worked for him, not his new wife. Under the circumstances, what should you do?**

A. Disclose the hidden assets to his wife.
B. Continue the relationship.
C. Fire the client and return his fees paid.
D. Fire the client and keep the fees.

Ans. D

9. ***Practice—practice standards*****. The following apply to the** ***Financial Planning Practice Standards*** **EXCEPT:**

A. Help practitioners focus on what to provide as part of the six-step financial planning process and base services on what clients need.
B. The Board of Practice Standards drafted ten standards.
C. The Practice Standards can be modified to reflect what practitioners actually do, as identified in future studies.
D. The Practice Standards require practitioners to provide comprehensive planning for clients.

Ans. D

10. ***Practice—practice standards*. Which of the following statements about the CFP Board's *Financial Planning Practice Standards* is correct?**

A. Practice standards are based on the daily activities of a personal financial planner.
B. Practice standards apply to all CFP designees regardless of the work they are doing.
C. The Practice Standards provide a basis for determining legal liability of financial planners.
D. The practice standards describe the expected level of professional practice to be followed by CFP designees.

Ans. D

11. ***Practice—balance sheet* (CFP® Exam, released 1/99). A client provides a current personal balance sheet to the financial planner during the initial data-gathering phase of the financial planning process. This financial statement will enable the financial planner to gain an understanding of all the following EXCEPT:**

A. Diversification of the client's assets
B. Size of the client's net cash flow
C. Client's liquidity position
D. Client's use of debt

Ans. B

12. ***Practice—cash flow.* Which of the following would not be included in cash flow?**

A. Taxes
B. Salaries
C. Auto note balance
D. Mortgage note payments
E. Interest income

Ans. C This would not be included in cash flow (included in net worth).

13. ***Practice—fundamentals.* Your client has a current net worth of $200,000. Last year, his net worth was $175,000. He had net cash outflows of $34,000, which included mortgage costs. His total cash inflows were $36,000. His investments appreciated $12,500 during the year. The value of all other assets remained the same. How much principal did he pay off?**

A. $2,000
B. $10,500
C. $12,500
D. $25,000

Ans. B His net worth increased by $25,000 last year ($200,000 – $175,000). The increase can be partially explained by his positive cash flows of $2,000 ($36,000 – $34,000) and the $12,5000 appreciation of his investments. The remaining $10,500 ($25,000 increase less $2,000 net cash flow less $12,500 appreciation) must be the reduction of the mortgage liability.

14. ***Practice—budgeting.* Which one of the following is not a discretionary expense?**

A. Mortgage
B. Gifts
C. Vacation
D. Savings

Ans. A

15. ***Practice—budgeting.*** **Which of the following is the logical first step in the budgeting process?**

A. Determine how much is to be saved or invested.
B. List all the categories and amounts of fixed expenditures.
C. Estimate all income and income sources.
D. Eliminate all discretionary expenditures.

Ans. C

16. ***Practice—emergency.*** **John and Jane Jones are in the 15 percent income tax bracket. What is the best option for their $20,000 emergency fund?**

A. GNMA fund
B. Money market fund
C. Exchange-traded fund
D. Hedge fund

Ans. B

17. ***Practice—liquidity.*** **All of the following are liquidity substitutes EXCEPT:**

A. Checking and savings accounts
B. Certificates of deposit (CDs)
C. Cash value of a life insurance policy
D. Fixed income mutual fund

Ans. D

18. ***Practice—bankruptcy.*** **Bob filed for Chapter 7 bankruptcy. What debts cannot be discharged?**

(1) Credit card debt
(2) Child support
(3) Alimony
(4) Personal debt
(5) Government loans

A. 1, 2, and 4
B. 1 and 4
C. 2, 3, and 5
D. 3, 4, and 5
E. All of the above can be discharged.

Ans. C

19. ***Practice—bankruptcy.*** **The following debts cannot be discharged in Chapter 7 EXCEPT:**

A. Child support
B. Alimony
C. Student loans
D. Unsecured debt

Ans. D

20. ***Practice—mortgages.*** **If a mortgage lender charges three "points" to the purchaser of a home with a $100,000 mortgage, the cost of these "points" is:**

A. $30
B. $300

C. $3,000
D. $30,000

Ans. C

21. ***Practice—lease versus buy*. Which of the following is the best reason to rent an apartment as opposed to purchasing a home?**

A. Do not want to pay property tax
B. Expect to relocate within one to three years
C. Do not want to tie yourself into doing yard work
D. Do not want to purchase any homeowner's insurance

Ans. B

22. ***Practice—FDIC.* Which one of the following is true regarding FDIC insurance?**

A. Reimburses the depositor for any losses up to $300,000
B. A depositor has to be a United States citizen.
C. T-bills purchased by an insured depository institution on a customer's behalf are not insured by the FDIC.
D. Deposits maintained in different categories of legal ownership are not separately insured.

Ans. C

23. ***Practice—SIPC.* Which one of the following is true regarding SIPC insurance?**

A. SIPC protects customers of broker-dealers even if the broker-dealer is not an SIPC member.
B. The cost of insurance is paid by all brokerage firms.
C. Broker-dealers that are registered with the SEC and members of the national security exchange must be members of the SIPC.
D. All types of deposits received by a financial institution in its usual course of business are insured.

Ans. C

24. ***Practice—client attitudes.* Which of the following is a trait found among risk-averters?**

A. They seldom change jobs.
B. They frequently change jobs.
C. They prefer change.
D. They are gamblers.

Ans. A

25. ***Practice—education.* Which of the following are needs-based programs?**

(1) Pell Grants
(2) Parent Loans for Undergraduate Students (PLUS)
(3) State prepaid programs
(4) Subsidized Stafford Student Loans

A. 1 and 2
B. 1 and 4
C. 2 and 4

D. 2 and 3
E. 1, 2, and 3

Ans. B

26. ***Practice—education.*** **Which of the following are needs-based programs?**

(1) Coverdell Education Savings Accounts
(2) Supplemental Education Opportunity Grants
(3) Perkins Loans
(4) Subsidized Stafford Student Loans

A. 1 and 3
B. 2 and 3
C. 2 and 4
D. 2, 3, and 4
E. 1, 2, and 4

Ans. D

27. ***Practice—education.*** **A client with adjusted gross income (AGI) of $55,000 wants to establish an education IRA. Which one of the following statements is true?**

A. With her AGI, she could contribute $3,000.
B. After five years, she could take distributions from the account tax free.
C. Any contributions she makes to the education IRA will reduce the allowable contributions she could make to a traditional IRA.
D. She could transfer the account to another beneficiary, such as a niece or nephew.

Ans. D

28. ***Practice—special circumstances.*** **Which of the following statements regarding same-sex couples is correct?**

A. If they register as a nontraditional family, the state laws of intestacy will treat them the same as if they were married.
B. Social Security survivor benefits can be directed to the same-sex partner.
C. For estate tax purposes, the unlimited marital deduction is not available.
D. When same-sex couples separate, the courts generally divide property in the same manner as if the couple had been married.

Ans. C

29. ***Practice—fiscal policy.*** **What can the federal government do to help get the economy out of a recession?**

(1) Decrease the national debt.
(2) Lower income taxes.
(3) Reduce any budget deficit.
(4) Increase government spending.

A. 1 and 2
B. 2 and 4
C. 3 and 4
D. 1, 2, and 4

Ans. B

30. ***Practice—monetary policy.*** **What mechanism(s) can the Federal Reserve use to help stimulate the economy?**

(1) Lower the discount rate.
(2) Lower the federal funds rate.
(3) Lower the prime rate.
(4) Sell Treasuries.
(5) Lower reserve requirements.

A. 1 and 2
B. 2 and 4
C. 1 and 5
D. 1, 4, and 5

Ans. C

31. ***Practice—monetary policy.*** **Which of the following entities controls monetary policy?**

A. Congress
B. Federal Reserve Bank of New York
C. Federal Open Market Committee (FOMC)
D. Federal Reserve Board
E. Executive branch

Ans. D

32. ***Practice—net present value.*** **An investor is considering purchasing an investment. His required rate of return is 12 percent. If he calculates the net present value of the investment and determines it to be 9.5, what do you know about the internal rate of return (IRR) of this investment?**

A. Nothing
B. The IRR is less than 12 percent.
C. The IRR is equal to 12 percent.
D. The IRR is greater than 12 percent.

Ans. D

33. ***Practice—future value.*** **Fifty years ago, you bought a share of stock for $10. The stock has paid no dividends during this period. It has yielded 20 percent over the past 50 years, compounded annually. What is your investment worth now?**

A. $10,000
B. $27,230
C. $45,502
D. $91,004

Ans. D N = 50; I/Y = 20; PV = −10; PMT = 0; CPTFV = $91,004.38

34. ***Practice—rate of return.*** **What rate of return will cause a $100 investment to turn into $300 over five years?**

A. 8 percent
B. 13 percent
C. 17 percent
D. 25 percent

Ans. D N = 5; PV = −100; FV = 300; PMT = 0; CPTI/Y = 24.57%

35. ***Practice—rule of 72.* If you invest $5,000 in a fund offering a rate of return of 12 percent per year, how many years will it take for your investment to reach $10,000 using the rule of 72?**

A. 5 years
B. 6 years
C. 7 years
D. 8 years

Ans. B If you use the rule of 72, you get 72/12 = 6 years.

36. ***Practice—uneven cash flows.* An investment is expected to produce the following end-of-year cash flows:**

Year 1 $500
Year 2 $200
Year 3 $800

If the required rate of return is 12 percent, what is the present value of this investment?

A. $925
B. $1,125
C. $1,175
D. $1,345

Ans. C Using your cash flow keys, $CF_0 = 0$; $CF_1 = 500$; $CF_2 = 200$; $CF_3 = 800$. NPV = $1,175.29. Or you can add up the present values of each single cash flow. PV_1 = N = 1, FV = 500, I/Y = 12; CPT PV = 446.43. PV_2 = N = 2; FV = 200; I/Y = 12; CPT PV = 159.44. PV_3 = N = 3; FV = 800; I/Y = 12; CPT PV = 569.42. Hence, 446.43 + 159.44 + 569.42 = $1,175.29.

37. ***Practice—mortgages.* Smith's wife has been hassling him about buying a house. She can have her dream home if they take out a $50,000 mortgage. How much interest will they pay over the life of the mortgage if they secure a 15-year note with 7 percent interest and make all their payments on time?**

A. $25,633
B. $27,294
C. $30,894
D. $35,275

Ans. C N = 180; I = .5833; PV = $50,000; FV = 0; solve for PMT = 449.41; 449.41 × 12 months × 15 years = $80,894; $80,894 − $50,000 = $30,894.

38. ***Practice–financial products.* A rep is a Series 6 licensed registered representative. Assuming she also has the appropriate state insurance licenses, what products can she sell?**

(1) Variable life insurance
(2) Mutual funds
(3) Variable annuities
(4) Exchange-traded funds

A. 1 and 2
B. 1, 2, and 3
C. 1 and 3
D. 1, 2, 3, and 4

Ans. B

39. ***Practice—RIA.*** **If Jones is a registered investment adviser, which of the following is permitted?**

A. Jones, CLU, ChFC, CFP®, RIA
B. Jones, CLU, ChFC, CFP®, R.I.A.
C. Jones, CLU, ChFC, CFP®, RIA™
D. None of the above

Ans. D

40. ***Practice—RIA.*** **If you are a registered investment adviser, what must you provide to clients?**

A. Nothing
B. SEC Form ADV, part I
C. SEC Form ADV, part II
D. SEC Form ADV, parts I and II

Ans. C SEC Form ADV, part II, must be provided to the client 48 hours before entering into the investment advisory contract or may be presented at the time of entering into the contract provided the client is given five business days to terminate the contract with no penalty.

41. ***Practice—RIA.*** **Registration of an investment adviser is accomplished by:**

A. Paying a filing fee and filing Form U-4 with the FINRA
B. Filing Form ADV-S
C. Filing Form ADV
D. Filing Form ADV-W

Ans. C

42. ***Practice—industry regulation.*** **Which of the following statements concerning the Investment Advisers Act's definition of a security is correct?**

A. The Act defines the term security in the broadest possible fashion.
B. The Act doesn't define the term security.
C. The Act uses a limited definition of the term security so that the term security includes only stocks, bonds, and certificates of deposit.
D. SEC hearings are periodically held to arrive at a definition of the term security.

Ans. A

43. ***Practice—industry regulation.*** **In order to be classified as an investment adviser, a person's activities must satisfy a three-pronged test. All of the following are "prongs" in the three-pronged test EXCEPT:**

A. The person provides general or specific advice about securities.
B. The person provides general advice that is incidental to a nonadvisory investment business and receives no compensation for services provided.
C. The person provides investment advisory services for compensation that is not incidental.
D. The person charges either a separate fee or receives compensation in the form of commissions.

Ans. B