

# **Pass the 66©**

**A comprehensive study guide for passing the NASAA Series 66 “Uniform Combined  
State Law Exam”**

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## The Series 66 Exam QuickFacts

- 100 questions plus 10 experimental
- 2.5 hours to complete – 150 minutes
- 71% required passing score (not 70%!)
- No limit to number of times individual can take exam
- Prometric and Pearson are two companies where the exam is given.
- Unlike the 65, the Series 66 requires a sponsor
- The Series 7 is a co-requisite for the 66. That means you can take and pass the two exams in any order but can only use the 66 when the Series 7 is also passed
- The Series 65 and 63 are the usual requirements for registering as an IAR or state-registered adviser. The Series 66 combines those two exams but requires the passing of the Series 7. The 66 is shorter than the 65 by 30 questions but requires a 71% to pass versus a 68.5%.
- More information on the exam at:  
[http://www.nasaa.org/industry\\_\\_\\_regulatory\\_resources/exams/733.cfm](http://www.nasaa.org/industry___regulatory_resources/exams/733.cfm)

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# **Chapter 1**

## **Investment Analysis, Recommendations, and Strategies**

**20 of 100 Questions on Series 66 Exam**

## Investing in Your Future

Have you ever wondered if you'll be able to stop working someday? Even if you keep at it well into your 70's, wouldn't it be nice to know you could afford to stop if you wanted? The answer to both questions is usually *yes*, which is why you are probably already saving for retirement through a 401(k) or IRA account. That means your retirement money is subject to factors such as inflation, interest rates, recessions, corporate profits, credit ratings and other important topics covered on the exam called the "Series 66." Actually "Series 66" is just the nickname for this test, which is properly entitled "The Uniform Combined State Law Examination." Notice how the word "law" is right there in the title. That's because this is primarily a test about securities law, rules and regulations. Approximately 80 of the 100 questions on your test will be concerned with regulatory issues for investment advisers, broker-dealers, agents, and investment adviser representatives.

There will also be many questions that relate directly to your own situation as an investor. This test will delve into the same economic and market factors that determine your success or failure to achieve your retirement goals. It will help you better understand your returns, your appetite for risk, your time horizon, your investment objectives, etc.

If you're not thinking about retirement yet, maybe you're wondering how you'll be able to afford college for your kids. Chances are, you will set up an investment account and use a mix of stocks, bonds, and money market securities to cover the ever-rising costs of higher education. If you're too aggressive in chasing after growth stocks, you could lose a big chunk of Junior's college fund. On the other hand, if you're too conservative in your investment choices, Junior might end up at junior college when you both had your hearts set on Harvard.

The purpose of this book is to help you pass the Series 66 exam, but we will try to help you do that by relating these topics to your own situation. We will speak to you in Plain English and use real-world examples that make sense and help you remember this material well enough to deal with the rather tricky questions the exam will throw at you.

If you aren't careful, you could end up actually enjoying this book and learning a few things that will help you understand your own investments a little better. But, really, we're just trying to help you pass the test.

If you bought the full package, you'll be able to do the suggested activities given at the end of each chapter, which means you can get started simply by reading the first chapter of the book and continuing from there. In fact, this *is* the first chapter of the book, so—guess what—you've already started studying for the Series 66. Congratulations. Let's keep the fun moving and start talking about clients of investment advisers.

Ready?

Too late—you've already started.

## **Client Profiles**

If you are taking the Series 66 exam, you are either starting your own investment advisory firm or you are going to sell the services of an investment advisory firm. Either way, you need to know as much as possible about your investing clients. You must gather key financial information such as:

- Income sources
- Current expenditures (bills, obligations)
- Discretionary income (what's left after paying bills)
- Assets (cash, real estate, pension/retirement accounts, life insurance)
- Tax bracket

Probably the most important figure to obtain from a client is known as “discretionary income” or “excess cash flow.” This is the money left over after covering all essentials. Because if the client has no money after paying “the bills,” he really has no money to invest. A personal income statement might look like this:

Monthly Income	
Salary	\$7,000
Investment Income	\$1,000
Other Income	<u>\$ 500</u>
<b>Total Monthly Income</b>	<b>\$8,500</b>
Monthly Expenditures	
Taxes	\$2,000
Mortgage Payment	\$2,000
Living Expenses	\$2,000
Insurance Premiums	\$ 300
Loan Payments	\$ 200
Travel/Entertainment	\$ 300
Other Expenses	<u>\$ 200</u>
<b>Total Monthly Expenses</b>	<b>\$7,000</b>
<b>Monthly Capital for Investing</b>	<b>\$1,500</b>

So, a client with the above income statement has excess cash flow or discretionary income of \$1,500. If you start talking him into investing \$3,000 a month in speculative investments . . . well, you'd never do a thing like that, right? Instead, you'd make recommendations that make sense given the fact that he has \$1,500 available for investing in a typical month. If he has a long time horizon of, say, 10+ years, the money could go into stock mutual funds investing for growth/capital appreciation. If he has a lower tolerance for wide fluctuations of yearly performance, he might choose growth & income, equity income, or balanced funds. And, if his time horizon is shorter, he might stay out of the stock market entirely and invest, instead, in short- or intermediate-term bond funds.

Of course, taxes always play a part in an investment strategy. If your client is in a high marginal tax bracket, you may want to recommend municipal bonds, which, generally, pay interest that is tax-exempt at the federal level. A high-tax-bracket client probably doesn't want to do a lot of short-term trading, either, since any gain taken within the space of a year will be taxed at the short-term capital gains rate (which equals the ordinary income rate). He also might want to buy stocks that pay qualified dividends rather than REITS or royalty trusts, which will force him to pay his ordinary income rate on the dividends. Or, maybe he puts the REITS and royalty trusts into a tax-qualified plan that allows the dividends to grow tax-deferred until withdrawn in retirement when he is in a lower tax bracket.

A business has both an income (earnings) statement and a balance sheet (statement of financial condition). So do your clients. Remember that assets represent what somebody owns, while liabilities represent what he owes. The difference would be his net worth. A client's assets would include the value of his home(s), automobiles, personal possessions (furniture, jewelry, Armani suits), investments, savings, and checking accounts. Liabilities would include mortgages and other loan balances, credit card balances, and, perhaps, debit balances in margin accounts.

A personal balance sheet might look like this:

Assets

House	\$400,000
Automobiles	\$ 30,000
Personal possessions	\$ 15,000
Stocks and Bonds	\$100,000
Keogh Plan	\$ 80,000
IRA	\$ 20,000
Checking	\$ 5,000
Savings Account	\$ 5,000
Money Market	\$ 5,000
<b>Total Assets</b>	<b>\$660,000</b>

Liabilities

Mortgage	\$250,000
Auto Loans	\$ 10,000
Credit Card Balances	<u>\$ 15,000</u>
<b>Total Liabilities</b>	<b>\$275,000</b>

Net Worth \$ 385,000

Since some assets are difficult to liquidate, we could exclude those items (house, limited partnerships, rental property) to calculate “liquid net worth.” If a client has high total net worth but low liquid net worth, an investment adviser might try to steer the client toward more liquid investments, like short-term debt versus a long-term zero

coupon bond, or heavily traded stocks and bonds as opposed to some funky thing trading on the Pink Sheets.

Watch out for a tricky test question that says that Joann Johnson recently took \$5,000 out of her savings account and paid down her mortgage balance by \$5,000—how much did that increase her net worth?

Not one penny. If you remove a \$5,000 asset in order to remove a \$5,000 liability, your net worth is unchanged. Joan's net worth will only rise if the value of her assets rises—the house appreciates, the value of the investments inside her IRA increases, etc. To check that, simply look at our balance sheet again and see what would happen to net worth if you removed the \$5,000 in savings in order to remove \$5,000 of the mortgage balance. Does the net worth change? What if the value of the house increased by \$20,000? What happens in that case? These are likely questions on the Series 66.

While gathering information on a client's assets, you're also uncovering his current securities holdings. Many investors have a huge percentage of their portfolio tied up in one company's stock—their employers'. If a client has too much money concentrated in just one stock, an advisor might advise him to sell some of that holding in order to diversify. Other clients will already be diversified, which is just as important to determine before recommending investments. If they already hold 20 large cap value stocks, you probably don't want to recommend that they plow the rest of their discretionary income into Dow Jones Index funds, which would be sort of redundant.

But there are also non-financial considerations, and these are just as important. So, you need a sort of personality profile of the investor:

- Age
- Investment experience
- Investment objective
- Need for withdrawals, liquidity
- Marital status
- Attitudes and values
- Number and age of children
- Employment stability
- Employment of family members
- Current and future educational needs for the family or individual
- Current and future health care needs

The questionnaire that the client fills out will try to gauge what is more important to the client—going for large returns or maintaining a stable principal. Do they need to withdraw a large portion of their portfolio at a moment’s notice? If so, let’s put that portion in the money market and short-term bonds. If they don’t have any real need to make withdrawals, then it’s probably okay to tie their money up long-term in the stock market, possibly even hedge funds. Remember that risk tolerance has to do with both the financial resources and the psychological resources necessary for sustaining wide fluctuations in market value and the occasional serious loss of principal that makes investing so much fun in the first place. The terms risk-averse, conservative, and low risk tolerance all mean the same thing—these investors will not tolerate big market drops. In fact, I wouldn’t even try to slip a small one past them. If somebody is risk-averse, steer them away from the following investments: small cap, emerging markets, sector/specialized funds, high-yield bonds, and aggressive growth. A low-risk investor might tolerate equity income funds, balanced funds, and investment-grade bond funds—the shorter the maturities, the better. High risk tolerance, aggressive, and speculative also go together, more or less. These investors will typically purchase the investments I just took off the table for the risk-averse client.

In general the longer the time horizon the more volatility an investor can withstand. If you have a three-year time horizon, you need to stay out of the stock market and invest, instead, in high-quality bonds with short terms to maturity. If you’re in for the long haul, on the other hand, who cares what happens this year? It’s what happens over a 20- or 30-year period that matters. With dividends reinvested the S&P 500 has historically gained about 10% on average, which means your money would double approximately every 7 years. Sure, the index can drop 30% one year and 20% the next, but we’re not keeping score every year—it’s where we go over the long haul that counts.

When the investor has a long time horizon and capital appreciation as an objective, we would probably recommend a “small cap fund,” or “growth stock” on the exam unless the question points out that she has only a moderate risk tolerance. In that case, the stock would be “large cap” or “blue chip.” If the exam makes you choose between large cap growth and large cap value, remember that growth is more aggressive

than value. In today's investing-as-science environment, the answers that a client gives concerning income needs, time horizon, investment objectives, and risk tolerance will automatically generate an asset allocation that might look like this:

- 20% large cap growth
- 25% large cap value
- 10% mid cap growth
- 15% mid cap value
- 20% long-term investment grade bond
- 10% tax-exempt money market

More aggressive answers to the client questionnaire would have increased the allocation toward stock and more toward mid- and small-cap growth stock versus large-cap growth or value. If the investor's answers are pointing out that they may need to withdraw much of this money over the short-term and would rather sacrifice potentially larger returns for safety of principal, we'd have to put a huge piece in the money market and keep it out of stocks.

Younger investors saving for retirement have a long "time horizon," so they can withstand more ups and downs along the road. On the other hand, when you're 69 years old, you probably need some income and not so much volatility in your investing life. So the farther from retirement she is, the more likely she'll be buying stock. The closer she gets to retirement, the less stock she needs and the more bonds/income investments she should be buying. In fact, you may have noticed that many mutual fund companies are taking *all* of the work out of retirement planning for investors, offering "target funds." Here, the investor picks a mutual fund with a target date close to her own retirement date. If she's currently in her mid 40's, maybe she picks the Target 2030 Fund. If she's in her mid 50's, maybe it's the Target 2020 Fund. For the Target 2030, we'd see that the fund is invested more in the stock market and less in the bond market than the Target 2020 fund. In other words, the fund automatically changes the allocation from mostly stock to mostly bonds as we get closer and closer to the target date.

As we'll see, an investment adviser often provides services to many different types of clients. On the adviser's brochure we would see which of the following he/they provide services to: individuals, high net worth individuals, banking or thrift institutions, investment companies, pension and profit sharing plans, hedge funds, charitable

organizations, corporations or other businesses, and state or municipal government entities. The Series 66 exam wants you to understand that different clients have different investment profiles.

### **Individuals**

If the client is an individual, the exam wants you to understand that an agent, broker-dealer, adviser, or adviser representative may only take orders from this individual. Not the individual's husband or wife, secretary, attorney, etc. Now, if your firm has third-party trading authorization on file, which means that somebody other than the client has the power to call up and enter orders, that's different—but make the question point out that this authority has been granted to somebody else by the client, with his/her legal signature. This trading authorization is sometimes called “power of attorney.” Limited trading authorization (power of attorney) means the other party may place buy and sell orders; full trading authorization (power of attorney) means the other party can do that as well as request a distribution of securities and/or cash, payable to the name on the account.

### **Joint Accounts**

When two or more people jointly own the assets in the account, we call it a “joint account.” All the owners sign a joint account agreement. We can take orders from any of the parties, and we can send mail to any of the parties. But, when we cut a check, it has to be payable to all names on the account. In other words, if the account is entitled Barbara Williams and Joann Stevens, Joint Tenants in Common, do not cut the check to Barbara and tell her to settle up with Joann next time they have lunch. Cut the check to “Barbara Williams and Joann Stevens, Joint Tenants in Common.” A Joint Tenants with Rights of Survivorship (JTWROS or JTROS) account gives the survivor rights to all the assets, meaning that if one account owner dies, the other owner (the survivor) owns all the assets, regardless of how much he/she put in. But, if the account is a Joint Tenants In Common (JTIC) account, when one party dies, the assets go to that person's estate. For JTIC accounts, the account owners would indicate what % each party owns in the account agreement, so we know what % goes to the estate. For JTWROS, that wouldn't matter, as all assets go to the survivor, bypassing probate court, should the exam decide to go there.

## Discretionary Accounts

When an adviser or broker-dealer can trade the customer's account without talking to the customer first, we call this situation a "discretionary account." In other words, what is purchased and sold for the customer is up to the firm's discretion or choosing. That means if the broker-dealer or adviser wants to buy 1,000 shares of MSFT, they can do so without even bothering to call the client. The client would have to sign a trading/discretionary authorization form, and the account would be reviewed more frequently, but that's about it. From then on, the firm can choose any of the following three A's:

- Action
- Asset
- Amount

That means the broker-dealer or advisory firm can choose whether to buy or sell, what to buy or sell, and how many shares to buy or sell without contacting the customer. Without discretionary authority no one can determine any of the three A's. Unless the account is a discretionary account, the only thing that can be determined is the time or price at which to execute a transaction. So, if a client calls you up and says, "Buy me some computer chip manufacturers today," do you need discretionary authority before you buy 100 shares of Intel?

Yes. If you choose the asset (or the activity, or the amount), that requires discretionary authority.

If a client calls up and says, "Pick up 1,000 shares of Intel today," do you need discretionary authorization? No, your client has chosen the asset (INTC), the action (buy) and the amount (1,000) shares. Only thing left for you to decide is the best time and price to do it, and time/price discretion does not require authorization.

Each discretionary order ticket would be marked "discretionary" at the broker-dealer and a particular principal would be assigned to make sure the securities purchased are appropriate and that the agent isn't churning in order to win the big trip to Hawaii. Advisers also have to keep detailed records of every discretionary order placed on behalf of clients. Remember that having the power to choose investments is often convenient, but the securities professional still has to purchase what is suitable for the client given her

objectives, time horizon, risk tolerance, and capital resources. If an investment professional purchases unsuitable investments for a discretionary account, it's not just a bad idea—it's a violation of SEC, NYSE and NASD rules. Just this morning, I read that the NYSE recently imposed a censure and a 6-month bar on a registered representative who misused his discretionary authority over an account. The state regulators and SEC have also been known to get their dander up when securities professionals abuse discretionary authority by buying unsuitable investments or simply use discretion when it has not actually been granted by the client.

## **Trust**

A trust account is run, not surprisingly, by a trustee. The trustee manages the account for the benefit of the “beneficiaries” of the trust and has to do things prudently and in keeping with the trust documents. The trustee is either an investment adviser or is using an investment adviser to manage the assets of the trust. Either way, the trustee would be ultimately responsible for choosing the right adviser and for what happens to the assets. The investment adviser must have a copy of the trust agreement on file. Establishing trusts is a key part of estate planning that can maximize the amount of money that passes from the deceased to his/her heirs, minimizing the amount that passes to Uncle Sam in the form of estate taxes. As we'll see, a trust is treated as a separate entity or “legal person,” just like a corporation, partnership, or estate.

[more information on trusts at [www.passthe66.com/updates](http://www.passthe66.com/updates)]

## **Estate**

An estate account is overseen by an executor, whose job is to *execute* legal and financial transactions on behalf of someone who has died. The executor is often just the oldest child in the family or the one who was assumed to be the best with numbers and paperwork. Grandma named Jason the executor of her estate in the legal document known as her will, for example. That means that Jason is responsible for distributing Grandma's bank accounts, investment accounts, farm land, house, etc. to the heirs named in the will. Maybe he and his two sisters each get a third. Or maybe a certain amount goes to the Salvation Army, a certain amount to Grandma's church, and then a whole set of specific percentages that correspond to Grandma's affection and lack thereof for each of the kinfolk. Jason might just be a trustworthy guy with a good head on his shoulders;

he might not actually know anything about investments. So, the executor might prefer to let an adviser manage the assets for a fee.

If it's a small estate in which the house is sold, the proceeds of that sale do not typically belong in some high-risk vehicle like emerging market funds or even the stock market in general. And any investment with front- or back-end sales charges is out. You don't put a client into something with a 5% front or back-end load when you know they'll be exiting and getting penalized in the near future, so a small investment into A-shares or any investment into B-shares would be a ticket to an early forced retirement. The proceeds of the house sale are typically going to be distributed to the kinfolk in a matter of a few months, so investing the money into the stock market or even the long-term bond market would make little sense. In general, an estate account just lets the money earn some interest until it all gets passed out to the heirs.

Of course, I would expect my adviser to charge a very low percentage of assets if the account is sitting in T-bills. It would be a little outrageous to pay a professional lots of money to put you in Treasury securities, which you can buy for zero commissions directly from the US Treasury at [www.treasurydirect.gov](http://www.treasurydirect.gov) and which subject you to zero default risk and almost zero interest rate risk. Then again, just having a professional steer you toward Treasuries and away from front-end-loaded emerging market mutual funds might be worth paying a reasonable fee. Instead of a percentage of assets, maybe you pay the adviser a few thousand dollars for keeping you out of some horrible alternative investment. It does sound old-fashioned somehow for an adviser to charge somebody for, you know, *advising* them. Not trading their portfolio or managing their assets, just charging them to sit there, stroke their chin a few times, and deliver the advice with authority. Buy T-bills and forget it, kid—that'll be two thousand dollars.

## **Business Ownership Structures**

### **Sole Proprietor**

If you're a handyman or a hair stylist, you typically have to pay for state and municipal licenses, so you might not want to also pay an attorney to set up a corporation or other business structure for you. Therefore, it might be tempting to just run your business as a sole proprietor. Perhaps you've noticed that a lot of folks who can fix your plumbing or coif your hair are just doing business as, you know, themselves. Unlike for

a corporation or other business structure, setting up a sole proprietorship doesn't require much in terms of time and expense. So, the advantages of opening your business as a sole proprietorship include:

- Faster, easier, cheaper set-up (corporations require set-up fees, often attorneys)
- Easy tax preparation (1040)

The trouble with being in business as a sole proprietor is that you remain personally liable for the debts and lawsuits against the business. In other words, you have not created a separate legal entity—you and the business are one in the same. If the sole proprietorship called Harry's Hotties accidentally sells 1,000 tainted hot dogs that send swarms of sick people to the emergency room, Harry is in a whole lot of trouble. All the lawsuits will be filed against Harry personally, and the creditors who used to spot him buns, hot dogs, and condiments are going to come after Harry personally for all the unpaid bills. Even if he has insurance, once the insurance is exhausted, the angry parties move directly to Harry, not to some corporate structure that would have added a layer of defense. The disadvantages of owning a business as a sole proprietor include:

- Personal liability (no separate legal entity)
- Harder to obtain loans or attract investment capital due to lower financial controls (financial statements and minutes not required)

Since a sole proprietor is an individual who owns a business that often operates on a shoe string budget, as an investor he or she has a large need for liquidity. In other words, they should not be tying up the majority of their money in emerging market funds, hedge funds, small cap growth stocks, mutual fund B-shares or variable annuities with steep surrender charges, etc. They should probably not even tie up too much capital in long-term bonds that are tough to exit at a fair price when interest rates are rising. Short-term debt securities will provide a regular stream of interest and a stable principal, which will help the sole proprietor deal with seasonal slowdowns, industry slumps, leaky roofs, etc. Depending on their risk tolerance, maybe they invest 70-80% of their money in debt securities with 2-year and shorter maturities, with 20-30% in large cap value or large cap growth stocks. That way as their liquidity needs are being met, their capital also has a chance of growing over the long-term, which could come in very handy when the entrepreneur wants to expand or wants to retire.

## **Partnerships**

As Robert Kiyosaki explains in his *Cash Flow Quadrant*, there is a big difference between being a self-employed professional and starting a business. Many business owners are really just cantankerous codgers who can't take criticism, let alone orders, from other people. So, they "go into business for themselves" and run everything as a sole proprietorship in which they control every aspect and answer to no one. We just looked at the pro's and con's of that business structure.

Another approach is to take on a partner, maybe several partners. What we're talking about here, of course, is a partnership. In a partnership, the income and expenses of the business flow through directly to the owners. The business entity, in other words, is not taxed. The percentage of profits and losses flowing through to the owners is stated in the partnership agreement. Does the partnership create a separate entity that shields the owners from liabilities of the business? Yes and no.

### **General Partnership**

The main difference between general and limited partnerships has to do with liability. In a general partnership, two or more persons own the business jointly and are still subject to creditors and lawsuits personally. Unless otherwise stated in the agreement, the general partners control the business jointly, equally, with one vote each. So, if Moe, Larry and Curly want to open a restaurant and maintain 33.3% ownership each, a general partnership may be the way to go. Of course, all three are personally liable should Curly spill hot soup on the wrong customer pursuant to a poke in the eye from Moe or Larry.

Basically, a general partnership is like a sole proprietorship with more than one owner. The owners agree to be in business together. They do not shield themselves personally from debts of the business.

### **Limited Partnership**

To form a limited partnership, there still has to be at least one *general partner*, who, as we just saw, has personal liability for debts and lawsuits against the business. But a limited partnership then has limited partners who maintain limited liability status, meaning they can only lose what they invest into the business. By "invest into the business" I mean the money they put in as well as any debts that they personally

guarantee. A debt that a limited partner signs his name to may be called a recourse note on the exam, meaning that creditors have recourse to come after him for the amount he guaranteed personally. A non-recourse note, then, would mean that the creditors have no recourse to collect this debt out of the investor's personal assets.

A limited partner is very interested in maintaining their/its limited liability status. To maintain the shield of protection, limited partners must stay out of day-to-day management decisions. So, if the exam asks if limited partners should be making regular management decisions, the answer is no. But, the LP's do get to vote on the big issues through something the exam might call "partnership democracy." Partnership democracy would be used to allow the LP's to have a voice on a limited number of items, such as:

- Dissolving the partnership
- Suing the GP for negligence, breach of fiduciary duty
- Inspecting certain records

The General Partner has a "fiduciary relationship" to the LP's, which means he/they must put the LP's needs first. In legal terms, the GP's fiduciary duty is "two-pronged," meaning he has a duty of loyalty and a duty of good faith. His duty of loyalty means he can't compete with the partnership. His duty of good faith means he has to do whatever he possibly can to run the business successfully and in accordance with the LP's best interests. The GP can end up getting sued by the LP's if it becomes clear that he/they are not meeting their duty to the limited partners through negligence or even outright fraud. If the GP is a lousy businessman who is really just using the partnership as a front for a bunch of personal expenses or gambling activities, that is not going to sit well with the LP's or the courts.

Since the GP has unlimited liability, the general partner is often a corporation rather than a natural person (human being). The corporate structure, as we'll see, provides a layer of protection.

Finally, when the partnership is liquidated, the senior creditors are paid first, then the unsecured creditors. The next priority is the limited partners, with the general partner last in line.

## LLC (Limited Liability Company)

A limited liability company (LLC) is a type of business ownership combining several features of the corporate and the partnership structures. Although it combines features of the corporation and the partnership, the limited liability company is *neither* a corporation *nor* a partnership. Because the LLC is neither a corporation nor a partnership, the owners are neither shareholders nor partners. They are, instead, called “members.” We will see that the S-Corp is limited to 75 shareholders, but the LLC has no limit on the number of members, who can be individuals, corporations, or *other LLC’s*. The owners and any officers and directors are protected from the liabilities of the company, including for their own negligence in operating the business. Advantages of setting up an LLC include:

- Limited Liability
- More flexible profit distributions (compared to most partnerships)
- No minutes (meetings not required, as opposed to corporations)
- Avoids double taxation of income

The exam may bring up the fact that to be structured as an LLC rather than a corporation, the LLC needs to avoid two of four corporate attributes. That means that it needs to avoid two of the following characteristics associated with corporations:

- Perpetual life
- Centralized management
- Limited liability
- Freely transferable assets

It’s almost impossible to avoid the centralized management, since the GP runs the business while the LP’s put up and shut up. It’s also tough to avoid limited liability as a, you know, limited liability company. So, how do they avoid the perpetual life and freely transferable assets associated with corporations? Unlike a corporation, an LLC has a limited life. For example, when the business is set up, perhaps it has a stated term of 30 years. The members also agree that they won’t sell their interests except according to a certain strict set of rules. For example, if you want to sell your interest to a stranger, the other members might have the right to buy the interest first to prevent that from happening, because who wants to suddenly be in business with a stranger? If one of the members got himself into debt, the members might discover they’re in business suddenly

with the guy's bookie, who wants to collect the debt through the seized profit interest in his hand. Much to the creditor's frustration, the other members could vote to *not* distribute profits. Of course, if the Series 66 brought that up as an advantage, it would be a seriously weird question. Then again, that probably makes it a likely candidate. In any case, the disadvantages of setting up an LLC include:

- Limited life
- Harder to attract financing (creditors don't like the idea explained above)
- More complexity than sole proprietorship (paperwork)

To set up a limited liability company, the business would file its articles of organization with the Secretary of State and pay the filing fees. The owners would also typically draft and sign an operating agreement. Similar to corporate bylaws or partnership agreements, these operating agreements spell out important points about ownership, responsibilities, and the distribution of profits.

## **S-Corps**

A very popular form of business ownership is the S-Corp. The S-Corp is a separate legal entity, so it offers some protection against debts and lawsuits compared to running the business as a sole proprietor. The income and expenses pass directly to the owners, so it's like a partnership or limited liability company in that sense. In other words, it avoids being taxed as a business entity, even as it provides that separate legal structure known as a corporation. The advantages of using the S-Corp structure include:

- No corporate tax (the entity is not taxed itself)
- Liability protection (compared to sole proprietor)
- Write-offs (early losses can offset personal income of the owners)

Of course, there are also disadvantages to the S-Corp, including:

- One class of stock
- 75 shareholders maximum
- Corporate meetings required

If your business is hoping to attract venture capital, the VC firms will not like the S-Corp structure with its direct flow-through of income and expenses and the limit of 75 shareholders. Also, all stock has equal voting rights and claims on profits, tying the hands of the financiers. And, even if it is a good idea, many business owners hate having

to hold an annual meeting where they have to talk like Thomas Jefferson and write down the minutes to the most boring two and a half hours this side of C-SPAN.

Oh well. If you want to create a business structure that offers some protection against debts and lawsuits and still avoid the double taxation of income, the S-Corp is an attractive option. More details on S-Corps include:

- The corporation can have no more than 75 shareholders with a husband and wife counting as one shareholder.
- Shareholders can be individuals, estates, and certain trusts.
- Shareholders must be American residents.
- The S-Corp must be a domestic company in any state.

## **C-Corps**

The C-Corp is the traditional corporate structure. When we were talking about common stock in General Electric, Microsoft, Oracle, etc., we were talking about C-Corps. In other words, since Microsoft has over 10 billion shares outstanding, it would be difficult to also be an S-corp, with its limit of 75 shareholders. This means that Microsoft is a separate legal entity that is taxed as a corporation—the profits do not flow directly through to large shareholders like Mr. Gates or even small shareholders like me. The corporation gets taxed on all those billions of dollars it makes year after year. Then, when the shareholders receive dividends on the stock, they are also taxed on that income. Yes, the tax rate has been reduced recently, but the dividend income is still taxable, even though the corporation already paid tax on those profits.

Unlike personal income tax rates, corporate rates are not graduated—if the corporation makes a profit, it simply pays x-percent of that number to the federal and often state governments. The phrase “franchise tax” is often just a phrase for a state income tax being levied on a corporation already paying income tax to Uncle Sam.

The by-laws of the corporation and the corporate charter govern the operation of the corporation. A broker-dealer or adviser would look at the corporate resolution to see who has the authority to place trades and/or withdraw cash and securities. When opening an account for a corporation, the broker-dealer or adviser would get the officers who are authorized to transact business on behalf of the corporation to sign a “certificate of incumbency,” which the firm keeps on file.

## Business Ownership Structures

TYPE	ADVANTAGE	DISADVANTAGES	TAXATION	LIABILITY
Sole Proprietor	Fast, Cheap Set-Up No meetings	Personal Liability	Personal income	Yes
General Partnership	Flow-Through of Income, Expenses	Personal Liability	Flow-Through to Owners	Yes
Limited Partnership	Flow-Through of Income Expenses	Must have 1 General Partner, with unlimited liability	Flow-Through to Owners	Not for limited partners
LLC	Flow-Through of Income, Expenses	Not good for attracting VC	Flow-Through to Owners	No, not even for negligence while running business
S-Corp	Flow-Through of Income, Expenses	Annual Meetings Not good for attracting VC 1 class of stock	Flow-Through to Owners	No
C-Corp	Attracting Capital	Double taxation of income Annual Meetings	Taxed as business entity	No, not even for negligence while running business

## Investment Risks

There is no safer investment than a fully insured bank CD or a United States Treasury security. These things will pay the promised interest and will return the principal every single time. So, since these investments are absolutely safe, why don't we all just put our money into these things and forget it?

Because even safety leaves investors with risk. There is purchasing power risk here, because the flat and low rate of interest paid on these safe investments seldom keeps up with rising prices/inflation. There is also opportunity cost, because the \$100,000 locked up in a bank CD isn't going to catch the next bull market for stocks or bonds.

So, if the investment meets the definition of a "security," there will always be some type of investment risk to explain to clients. One of the best ways to understand investment risks is to read through the first pages of several different mutual fund prospectuses. If you have a few available, I recommend reading through a prospectus for a growth fund, a bond fund, and a money market fund, at a bare minimum.

## Stock Market

I'm looking at the prospectus for a growth fund myself at the moment, which declares that its investment goal is "growth of capital." It then says that "dividend income, if any, will be incidental to this goal." In other words, the fund invests in growth stocks but some companies that are expected to grow will also pay dividends and this