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Securities Industry Essentials Exam (SIE)

FINRA SIE

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Topic Break Down

Topic	No. of Questions
Topic 1, Knowledge of Capital Markets	23
Topic 2, Understanding Products and Their Risks	207
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QUESTION NO: 1

Under which of the following circumstances, if any, is it permissible for an individual without a Power of Attorney (POA) to sign a customer's name on their behalf?

A. Upon approval by a firm principal

B. Upon receipt of verbal authorization provided that written authorization is subsequently provided

C. When accounts are fully discretionary

D. Never permissible to sign a customer's name on their behalf

ANSWER: D

Explanation:

Never permissible to sign a customer's name on their behalf is correct. A registered representative or other associated person must not sign a customer's name to account documents, transaction forms, checks, agreements, or other records when that person lacks a power of attorney or other legally valid authority to execute documents for the customer. A customer signature is an important control: it evidences that the customer reviewed, approved, and authorized the relevant document or instruction. Signing in the customer's name without the required authority compromises that control and can create an inaccurate firm record, as well as serious regulatory, civil, and potential criminal consequences. This principle remains especially important in securities accounts because FINRA requires firms to maintain customer account records and to exercise diligent supervision over associated persons' activities. Written discretionary authorization permits a representative to exercise investment discretion within its scope, but it does not itself authorize the representative to execute documents by writing the customer's signature. FINRA's standards of commercial honor and just and equitable principles of trade also govern such conduct. See FINRA Rule 2010 and FINRA Rule 4512.

QUESTION NO: 2

An investor holds 1,000 shares of a stock with a total cost basis of $5,000 in his account when a 1-for-5 reverse stock split is announced. What will be the investor's total cost basis after the payable date of the reverse split?

A. $1,000

B. $2,500

C. $5,000

D. $25,000

ANSWER: C

Explanation:

The correct answer is **$5,000**. A reverse stock split changes the number of shares outstanding while proportionally changing the per-share value; it does not, by itself, create a gain, loss, or change in the investor's aggregate tax basis. In a 1-for-5 reverse split, each five pre-split shares become one post-split share. Therefore, the investor's 1,000 shares become 200 shares. The original aggregate basis of $5,000 carries over to those 200 shares, producing an adjusted basis of $25 per share ($5,000 ÷ 200 shares). Although the share count is reduced and the per-share basis rises, the total basis remains $5,000. This basis adjustment is important because the investor will use the adjusted per-share basis, together with the number of shares sold, to calculate gain or loss if the shares are later disposed of. FINRA explains that stock splits and reverse stock splits adjust the number of shares and stock price proportionally without changing the investor's overall position value at the time of the split. The IRS likewise addresses stock-split basis adjustments in its guidance on investment property. See FINRA's stock investing overview and IRS Publication 550, Investment Income and Expenses.

QUESTION NO: 3

An investor wants to purchase mutual fund shares, but she is concerned about the tax efficiency of the fund. Which of the following disclosures required under industry regulations will help the investor make an informed decision?

A. The fund ' s turnover ratio

B. Sales charges and breakpoint discount opportunities

C. The commissions that the fund pays on each transaction

D. Projections of future dividend and capital gains distributions

ANSWER: A

Explanation:

The fund ' s turnover ratio is the disclosure most directly useful for evaluating a mutual fund's potential tax efficiency. Portfolio turnover measures the frequency with which a fund buys and sells securities during a year, generally expressed as a percentage of the fund's average portfolio value. A higher turnover rate can indicate more frequent realization of gains within the portfolio. For a taxable investor, realized net capital gains may be distributed to shareholders, creating taxable capital-gains distributions even when the investor has not sold fund shares. Reviewing turnover therefore helps an investor assess whether the fund's investment approach is likely to involve substantial trading and potentially more taxable distributions.

Mutual funds must disclose their portfolio turnover rate in the prospectus financial highlights information under SEC registration requirements. This figure is not a prediction of a particular year's tax bill, since distributions also depend on market performance, losses available to offset gains, redemptions, and the manager's tax-management practices. It is nevertheless a meaningful standardized data point for comparing funds with similar strategies, especially when choosing investments for a taxable account. The SEC's investor guidance discusses the importance of reviewing fund prospectuses and fees, while Form N-1A specifies the prospectus disclosure framework for registered mutual funds. See SEC Investor.gov: Mutual Funds and SEC Form N-1A requirements.

QUESTION NO: 4

Which of the following types of accounts permits an investor to borrow money from a broker-dealer to help pay for a trade?

A. Cash

B. Margin

C. An individual retirement account (IRA)

D. Delivery versus payment (DVP) / receive versus payment (RVP)

ANSWER: B

Explanation:

Margin is correct because a margin account permits a customer to borrow funds from their broker-dealer to purchase eligible securities. The broker-dealer extends credit, and the securities in the account generally serve as collateral for that loan. Before opening the account, the customer must receive and agree to a margin agreement, which discloses the terms of borrowing and the firm's rights regarding collateral. Margin borrowing increases purchasing power, but it also creates leverage: both gains and losses are magnified. Customers must maintain required equity in the account and may be subject to a margin call if the account value declines. If additional funds or securities are not deposited when required, the broker-dealer can sell securities in the account to satisfy the maintenance requirement, potentially without contacting the customer first. FINRA's margin rules establish baseline requirements for extension of credit by member firms, while Regulation T of the Federal Reserve Board governs initial margin requirements for many securities transactions. See FINRA Rule 4210: Margin Requirements and the SEC's margin investing overview.

QUESTION NO: 5

Which of the following entities issues certificates of deposit (CDs)?

A. FDIC

B. Banks

C. Broker-dealers

D. Federal Reserve

ANSWER: B

Explanation:

Banks issue certificates of deposit (CDs). A CD is a deposit account in which a customer agrees to leave money at a bank for a stated term, such as several months or several years. In exchange, the bank generally pays a specified rate of interest. At maturity, the depositor receives the principal amount plus accrued interest, subject to the terms of the account. CDs are therefore liabilities of the issuing bank: the bank accepts the customer's funds and has an obligation to repay those funds under the CD's terms.

For SIE purposes, it is important to distinguish issuing a CD from insuring or distributing one. When issued by an FDIC-insured bank, deposit insurance generally covers qualifying deposit accounts, including CDs, up to the applicable standard insurance limit per depositor, per insured bank, per ownership category. Brokered CDs may be made available to customers through brokerage firms, but the underlying CD is still issued by the bank. FINRA describes bank products, including CDs, in its investor guidance, and the FDIC explains deposit insurance coverage for CDs and other deposit accounts. See FINRA's CD overview and the FDIC deposit insurance FAQs.

QUESTION NO: 6

A registered representative (RR) reads an article online about a thinly traded security that the RR believes has a high likelihood of rapid growth and price appreciation. The RR purchases shares of the security in their own account and recommends to a number of high net worth customers that they purchase shares as well. After the RR ' s customers make several purchases of the security, the price appreciates, as the RR expected. The RR liquidates their position for a profit and subsequently recommends to customers that they do the same thing. Which of the following statements is true regarding this scenario?

A. This is a deceptive practice that violates FINRA conduct rules.

B. This is an acceptable practice if the customers ' profits were equal to or greater than the RR ' s.

C. The RR ' s recommendations are appropriate as the customers are all high net worth individuals.

D. The RR violated FINRA rules that state RRs are only permitted to accept unsolicited orders for thinly traded securities.

ANSWER: A

Explanation:

This is a deceptive practice that violates FINRA conduct rules. The representative establishes a personal position in a thinly traded security, recommends that customers purchase it, and then sells after the customer purchases contribute to the anticipated price increase. This conduct creates a serious conflict between the representative's personal financial interest and the duty to deal fairly with customers. In a thinly traded security, even relatively modest demand can have a meaningful effect on market price, making the representative's use of customer recommendations to benefit the representative's own account especially problematic.

FINRA Rule 2010 requires members, in conducting their business, to observe high standards of commercial honor and just and equitable principles of trade. A representative's undisclosed use of customer recommendations to support a personally beneficial trading strategy is inconsistent with those ethical obligations. The conduct may also implicate FINRA Rule 2020, which prohibits transactions or activities that create actual or apparent active trading in, or raise or depress the price of, a security for the purpose of inducing others to buy or sell it. The key issue is not merely that the representative held the security, but that the representative used recommendations to customers while planning to profit from the resulting price movement. See FINRA Rule 2010 and FINRA Rule 2020.

QUESTION NO: 7

Which of the following statements is true about a general obligation (GO) municipal bond?

A. It does not carry an attached legal opinion.

B. It carries no exemption from federal or state income taxes.

C. It is backed by the full faith and credit of the issuing jurisdiction.

D. It is payable solely from the revenues of the facility against which the bonds were issued.

ANSWER: C

Explanation:

A general obligation municipal bond is backed by the full faith and credit of the governmental issuer, meaning the issuer pledges its taxing power and general revenues to make timely interest and principal payments. For a state issuer, this backing generally rests on its broad taxing authority. For a local issuer, such as a city, county, or school district, repayment is typically supported by property taxes and may be subject to statutory, constitutional, or voter-approved limits on taxation. The investor therefore evaluates the issuer's overall financial condition, tax base, budget practices, debt burden, and ability to raise revenue, rather than relying on income from a single project. GO bonds are commonly issued to finance public-purpose capital improvements, including schools, roads, and other community infrastructure. In contrast to bonds secured only by a specific project's or facility's revenues, the general obligation pledge gives bondholders a claim on the issuer's general resources as provided in the bond authorization and applicable law. FINRA's municipal-bond educational material distinguishes general obligation bonds from revenue bonds on this basis. See FINRA's overview of bond types and the MSRB guide to understanding municipal bonds.

QUESTION NO: 8

The provision that allows a bond issuer to purchase bonds from customers prior to the maturity date on the bond is known as a:

A. Put

B. Call

C. Conversion

D. Defeasement

ANSWER: B

Explanation:

Call is correct. A call provision gives the bond issuer the contractual right to redeem, or "call," outstanding bonds before their scheduled maturity date. When an issuer exercises this right, it pays bondholders the applicable call price, which may be at par or, particularly for an early call, include a stated call premium. The issuer commonly calls bonds when prevailing interest rates have declined since the bonds were issued. It can then retire the higher-coupon debt and potentially issue new debt at a lower interest rate, reducing its borrowing costs.

For an investor, callable bonds have reinvestment risk: if a bond is called during a period of lower market rates, the investor may have to reinvest the returned principal at a lower yield. Callable features and their terms—including call dates, call prices, and any call protection period—are disclosed in the bond's offering documents. FINRA's investor education materials describe callable bonds as bonds that an issuer may redeem before maturity, while the SEC's investor guidance discusses the risks and features investors should review in bond offerings. See FINRA's Bonds overview and the SEC Investor.gov bond guidance.

QUESTION NO: 9

Which of the following entities is an investment company?

A. A variable annuity

B. A private equity fund

C. A unit investment trust (UIT)

D. A real estate investment trust (REIT)

ANSWER: C

Explanation:

A unit investment trust (UIT) is an investment company under the Investment Company Act of 1940. A UIT pools money from investors and issues redeemable units that represent an undivided beneficial interest in a defined portfolio of securities. Unlike an actively managed mutual fund, a UIT generally has a fixed portfolio and a stated termination date; however, its fixed nature does not change its status as an investment company. UITs are one of the principal forms of registered investment companies, together with open-end management companies (mutual funds) and closed-end management companies. For SIE purposes, the essential point is that a UIT provides investors with a pooled, professionally assembled securities portfolio through units issued by the trust. FINRA describes UITs as investment companies that buy and hold a generally fixed portfolio of securities, while the SEC identifies UITs as a category of investment company regulated under the Investment Company Act. See FINRA's Unit Investment Trusts overview and the SEC's Investment Company Act resources.

QUESTION NO: 10

Which of the following statements best describes the market maker system of trading and execution?

A. One market maker is responsible for maintaining a fair and orderly market for all market participants.

B. Multiple market makers compete with each other in displaying bids and offers to the general marketplace.

C. Individual market participants negotiate with each other to execute orders through a designated market maker.

D. All orders are transmitted to a designated market maker for review before being displayed to the broader market.

ANSWER: B

Explanation:

Multiple market makers compete with each other in displaying bids and offers to the general marketplace. A market maker is a broker-dealer that is willing to buy and sell a particular security for its own account on a regular or continuous basis at publicly quoted prices. Its bid states the price at which it is willing to purchase, while its offer (or ask) states the price at which it is willing to sell. By continuously posting two-sided quotations and committing firm capital, market makers provide readily available liquidity for investors seeking to trade.

The defining feature of the market maker system is competition among dealers. More than one market maker may quote the same security, and each may establish its own bid and offer based on market conditions, inventory, customer interest, and risk. Competition to provide the best displayed prices can narrow bid-ask spreads, improve available depth, and promote efficient price discovery and execution. This is the core market-structure distinction tested on the SIE: trading may occur against dealer quotations rather than requiring a buyer and seller to locate and directly negotiate with one another. FINRA's SIE content outline includes market makers, quotations, and trading markets within the exam's securities-markets knowledge area. See FINRA's SIE Content Outline and the SEC's overview of market makers.

QUESTION NO: 11

A bond with a par value of $1,000 that is backed by the taxing power of a local government is known as:

A. A revenue bond

B. A Treasury bond

C. A corporate bond

D. A general obligation (GO) bond

ANSWER: D

Explanation:

A general obligation (GO) bond is correct because it is a municipal security supported by the issuer's ability to levy and collect taxes. A state, city, county, school district, or other governmental issuer generally uses the proceeds of GO bonds to finance public-purpose projects and services, such as schools, roads, or public facilities. Rather than depending primarily on income from one specific project, payment of principal and interest is based on the governmental issuer's general taxing authority and overall creditworthiness. The phrase "backed by the taxing power of a local government" is therefore the central identifying feature of a GO bond. The $1,000 par value is a common denomination for municipal bonds, but it does not determine the type of bond; the source of repayment does. Investors evaluating a GO bond should consider factors affecting the municipality's capacity and willingness to raise tax revenue, including its tax base, finances, and applicable legal or voter-imposed limits on taxation. FINRA describes general obligation bonds as municipal bonds backed by the full faith, credit, and taxing power of the issuer. See FINRA's Types of Municipal Bonds and the SEC's Municipal Bonds Investor Bulletin.

QUESTION NO: 12

An investor is bullish on the technology sector and heavily invests in microchip companies. Impactful regulatory changes are announced that will negatively affect microchip manufacturing. In order to mitigate the risk to his portfolio, the investor should:

A. Purchase holdings uncorrelated to the technology sector.

B. Purchase shares of other microchip companies in the technology sector.

C. Sell holdings that are unaffected by the regulatory changes.

D. Buy more shares of the microchip companies already in his portfolio.

ANSWER: A

Explanation:

Purchase holdings uncorrelated to the technology sector. The announced regulations create a risk that is concentrated in a particular industry and sector rather than a risk affecting all securities and markets alike. Because the investor is heavily concentrated in microchip companies, adverse developments affecting chip manufacturing may cause many existing positions to decline together. Adding investments whose returns are not closely correlated with the technology sector—such as securities in other sectors or other asset classes, as appropriate for the investor's objectives and risk tolerance—can reduce the portfolio's exposure to a single industry-specific event. This is the central benefit of diversification: spreading investments among assets, issuers, industries, and/or asset classes so that a problem affecting one area has a less severe effect on the overall portfolio. Diversification cannot eliminate market risk, and it does not guarantee against losses, but it can mitigate non-systematic risk arising from concentration in a particular company, industry, or sector. FINRA describes diversification as allocating investments among various financial instruments, industries, and other categories to reduce risk. See FINRA's diversification overview and the SEC's investor guidance on risk and diversification.

QUESTION NO: 13

Which of the following types of stock refers to the maximum number of shares a corporation is legally permitted to issue, as specified in its articles of incorporation?

A. Issued stock

B. Treasury stock

C. Restricted stock

D. Authorized stock

ANSWER: D

Explanation:

Authorized stock is the maximum number of shares that a corporation may legally issue under its articles of incorporation, sometimes called its corporate charter. At formation, the corporation specifies this amount as part of its capitalization structure. The corporation can issue shares up to that authorized limit, including shares used to raise capital, compensate employees, or complete acquisitions. It need not issue all authorized shares at once; the difference between authorized shares and issued shares represents capacity for future issuance. If the company needs authority to issue more shares than its charter permits, it generally must amend its articles of incorporation in accordance with applicable state corporate law and its governing procedures, commonly involving shareholder approval. This distinction is important to investors because additional issuances from authorized but unissued shares can increase the total shares held by investors and may affect ownership percentages. The SEC's investor education materials describe authorized shares as the number of shares a company may issue under its charter, while issued shares are those that have actually been issued. See the SEC's Investor Bulletin on stock splits and FINRA's Stocks overview for foundational equity-security information.

QUESTION NO: 14

Comparative performance statistics of competing mutual funds are available through which of the following sources?

A. The prospectus

B. Shareholder reports

C. Independent fund rating services

D. The statement of additional information

ANSWER: C

Explanation:

Independent fund rating services are the appropriate source for comparative performance statistics involving competing mutual funds. These services collect and standardize information across many fund complexes, then organize funds into comparable categories based on investment objective and portfolio characteristics. Their reports commonly provide historical returns for standardized periods, peer-group rankings, expense information, volatility and risk measures, and risk-adjusted performance data. This gives an investor a practical means to evaluate how one fund has performed relative to similar funds managed by other advisers, rather than reviewing each fund's disclosures separately.

For SIE purposes, it is important to distinguish comparative third-party information from a mutual fund's own required disclosure materials. Independent services are designed to facilitate market-wide and peer-group comparisons and may include ratings or analytical tools that help investors assess a fund's performance record in context. FINRA notes that investors can research mutual funds using independent resources and should consider performance alongside fees, risks, and investment objectives. The SEC also explains that fund performance information must be presented using standardized periods in disclosure documents, which supports consistent evaluation when data are aggregated by independent comparison services. See FINRA's mutual fund overview and the SEC's mutual fund investor bulletin.

QUESTION NO: 15

A customer owns a substantial position in a technology stock and is concerned about a decline in the stock's value over the next three months but does not want to sell the shares. Which of the following strategies provides the most direct hedge against that risk?

A. Buy a put on the stock

B. Sell a call on the stock

C. Buy a call on the stock

D. Sell the stock short

ANSWER: A

Explanation:

Buying a put on the stock provides the most direct hedge. A put gives its holder the right to sell the underlying stock at the strike price. If the stock declines, the put's value generally rises, helping offset losses in the long stock position.

Selling a call may generate premium income, but it does not establish a minimum sale price and leaves the investor exposed to a substantial decline in the stock. Buying a call benefits from a price increase, while selling the stock eliminates rather than hedges the stock position.

QUESTION NO: 16

A corporate bond is convertible into 40 shares of the company's common stock and is purchased at par value. If converted by the bondholder, what will be his per-share cost basis?

A. $25

B. $40

C. $250

D. $400

ANSWER: A

Explanation:

$25 is the correct per-share cost basis. A corporate bond's standard par value is $1,000. When the bondholder converts a bond purchased at par into 40 shares of the issuer's common stock, the holder's original $1,000 investment becomes the cost basis allocated across the shares received. Dividing the bond's $1,000 cost by the 40 shares received produces a per-share basis of $25 ($1,000 ÷ 40 = $25). In convertible-bond terminology, 40 shares is the conversion ratio, and $25 is the conversion price implied by the bond's par value and that ratio. This calculation measures the effective price paid for each share through conversion; it does not depend on the common stock's current market price at the time of conversion. Convertible securities combine a bond's debt characteristics with a contractual right to exchange the bond for a stated number of common shares, making conversion terms central to evaluating the instrument. FINRA's SIE content outline includes debt securities and the features of convertible securities within its products-and-risks coverage. See FINRA's SIE Content Outline and the SEC's Investor Bulletin on Convertible Securities.

QUESTION NO: 17

An individual investor has $300,000 in cash and $400,000 in securities held with a financially troubled SIPC member firm for which liquidation has begun. The individual investor's cash is protected for what amount?

A. $150,000

B. $250,000

C. $300,000

D. $700,000

ANSWER: B

Explanation:

$250,000 is the amount of this investor's cash protected by SIPC. When a SIPC-member brokerage firm enters liquidation, SIPC protection applies to a customer's net equity claim, subject to a maximum of $500,000 per customer. Within that overall maximum, protection for cash is capped at $250,000. The investor has a combined account claim of $700,000, consisting of $300,000 in cash and $400,000 in securities. Although the securities and cash together exceed the general $500,000 ceiling, the specific question asks for the amount of cash protected. Because the customer's $300,000 cash balance exceeds SIPC's separate cash limit, SIPC protection for the cash portion is limited to $250,000. SIPC is designed to restore missing customer cash and securities when a member brokerage fails; it does not protect against investment losses caused by market declines. The applicable $500,000 overall limit and $250,000 cash sublimit are described by the Securities Investor Protection Corporation and in FINRA's investor guidance on SIPC protection.

QUESTION NO: 18

A husband and wife are interested in purchasing unregistered securities in an SEC Regulation D offering for their joint account. In order to be considered accredited, they must have had a combined annual income for each of the past two years and current expectations for this year of at least what amount?

A. $200,000

B. $300,000

C. $400,000

D. $500,000

ANSWER: B

Explanation:

$300,000 is the applicable joint-income threshold under the natural-person accredited-investor definition in SEC Regulation D. A person qualifies through the income test if the person had individual income exceeding $200,000 in each of the two most recent years, or joint income with that person's spouse (or spousal equivalent) exceeding $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year. Because the investors are a husband and wife purchasing for their joint account, their combined income is evaluated under the joint-income standard. The threshold is measured for each of the two prior years—not as an average—and the expected current-year income must meet the same $300,000 level. Accredited-investor status may permit participation in certain private offerings conducted under Regulation D, subject to the particular exemption and offering terms. The SEC's accredited investor overview and the text of Rule 501(a) identify this income-based qualification and its joint-income amount. See the SEC's Accredited Investors guidance and 17 CFR § 230.501.

QUESTION NO: 19

A registered representative (RR) owns 500 shares of a thinly traded security. A customer of the firm calls the RR to place a sell order for 10,000 shares of the same security. The RR sells his shares before entering the customer ' s order to sell. Which of the following activities has the RR just engaged in?

A. Selling away

B. Front running

C. Insider trading

D. Market manipulation

ANSWER: B

Explanation:

Front running is correct. The registered representative has advance knowledge of a pending customer sell order and uses that information to trade personally before the customer's order is entered. Because the security is thinly traded, a sell order for 10,000 shares could reasonably be expected to affect the market price, potentially causing the price to decline. By selling the representative's own 500 shares first, the representative seeks to avoid the adverse price impact that may result once the customer's much larger order reaches the market. This places the representative's personal interest ahead of the customer's interest and misuses nonpublic information about the customer's imminent transaction.

FINRA's customer-order protection rule generally prohibits a member from trading for its own account on the same side of the market at a price that would satisfy a held customer order until that customer order has been executed. This principle is designed to ensure that customer orders receive appropriate priority and that associated persons do not profit from, or avoid losses through, advance knowledge of customer trading activity. See FINRA Rule 5320 and FINRA's stock-investing overview.

QUESTION NO: 20

A summary prospectus for a mutual fund must contain which of the following information?

A. Projected return

B. Investment objectives

C. Fund ' s portfolio holdings

D. Control persons and principal owners of the fund

ANSWER: B

Explanation:

Investment objectives is correct because a mutual fund's summary prospectus is required to give investors a standardized, concise description of the fund's essential characteristics. The investment objective identifies the fundamental purpose of the fund—for example, whether it seeks current income, capital appreciation, preservation of capital, or a combination of those goals. This information helps an investor assess whether the fund's intended strategy aligns with the investor's own financial goals, time horizon, and risk tolerance.

Under Securities and Exchange Commission Form N-1A requirements, the summary section of a fund prospectus must disclose the fund's investment objectives or goals, along with other key items such as principal investment strategies, principal risks, fees and expenses, performance information, and management information. The summary prospectus framework is designed to make these core disclosures readily available while allowing investors to obtain the full statutory prospectus and other detailed fund documents online or upon request. See the SEC's summary prospectus rule release and Form N-1A requirements.

QUESTION NO: 21

Which of the following statements is true of the writer of a listed equity call option?

A. They have the right to sell stock at a fixed strike price.

B. They have the right to buy stock at a fixed strike price.

C. They have the obligation to sell stock at a fixed strike price.

D. They have the obligation to buy stock at a fixed strike price.

ANSWER: C

Explanation:

The writer of a listed equity call option has the obligation to sell the underlying stock at the option's fixed strike price if the holder exercises the call. A call option gives its holder the contractual right to purchase the underlying shares at the strike price during the exercise period. By taking the other side of that contract and receiving the option premium, the call writer accepts the corresponding duty to deliver or sell the shares if assigned an exercise notice. This obligation exists whether the call was written covered, with the writer already owning the shares, or uncovered, in which case the writer may need to acquire shares in the market to meet delivery obligations. Listed equity options are standardized contracts, generally representing 100 shares per contract, although adjusted contracts can have different deliverable terms after corporate actions. The Options Clearing Corporation serves as the central clearing agency for listed options and assigns exercised contracts to clearing members, whose customers may then be assigned. Therefore, “They have the obligation to sell stock at a fixed strike price” accurately describes the position of a call writer. See the Options Clearing Corporation’s overview of listed options clearing and FINRA’s options investor resource.

QUESTION NO: 22

Which of the following market participants serve as intermediaries between buyers and sellers to ensure that trades are settled correctly?

A. Exchanges

B. Investment advisers

C. Market makers

D. Clearing corporations

ANSWER: D

Explanation:

Clearing corporations are the intermediaries that stand between the parties to a securities transaction in the clearing and settlement process. After a trade is executed, the clearing process matches and confirms trade details, calculates each participant’s delivery and payment obligations, and facilitates the exchange of securities for funds at settlement. A clearing corporation may also become the central counterparty through novation, meaning it assumes the buyer’s obligation to every seller and the seller’s obligation to every buyer. This structure reduces counterparty exposure and supports the orderly completion of a large volume of transactions. In the United States, registered clearing agencies perform this essential market-infrastructure role; for example, the National Securities Clearing Corporation clears many broker-dealer equity and corporate-debt transactions. FINRA’s SIE content outline includes clearing corporations among the key financial intermediaries and describes their role in clearing and settling securities transactions. The Securities and Exchange Commission similarly explains that clearing agencies provide the mechanisms for comparison, clearance, and settlement of securities transactions. See the FINRA SIE Content Outline and the SEC’s clearing-agency overview.

QUESTION NO: 23

A registered representative constructs a portfolio of stocks that replicates the S & P 500 Index (SPX). He then regularly buys and sells SPX options to profit off changes in implied volatility. This is an example of:

A. day trading.

B. Index rebalancing.

C. active management.

D. passive management.

ANSWER: C

Explanation:

active management. is correct because the representative is making ongoing discretionary trading decisions designed to generate returns from anticipated changes in implied volatility. Although the stock portfolio initially replicates the S&P 500 Index, regularly establishing and closing SPX option positions introduces an actively managed options strategy rather than merely maintaining index exposure. Implied volatility is a key input to an option’s premium, and a trader who seeks to profit from expected volatility changes is taking tactical market positions based on a forecast. That requires monitoring, judgment, and repeated transactions—the central characteristics of active management. The fact that the underlying equities track an index does not change the active nature of the overall portfolio when the representative overlays it with frequent options trades intended to add returns from volatility movements. FINRA’s SIE content outline specifically includes options, index products, and investment strategies among the concepts tested, including the risks and uses of these products. The SEC also explains that options have values affected by factors including volatility, supporting the conclusion that trading them based on expected implied-volatility movements is an active strategy. See FINRA’s SIE Content Outline and the SEC Investor Bulletin on Options.

QUESTION NO: 24

Which of the following activities engaged in by a registered person is considered a private securities transaction?

A. Soliciting donations to a charity

B. Helping a friend raise money for a startup company they founded

C. Working for an insurance company selling term life insurance policies

D. Investing personal money in shares of a listed security in a brokerage account

ANSWER: B

Explanation:

Helping a friend raise money for a startup company they founded is a private securities transaction when the registered person participates in obtaining investors or facilitating the sale of the startup’s securities outside the regular course or scope of the person’s employment with their FINRA member firm. A startup fundraising commonly involves an offer or sale of an ownership interest, such as stock, membership interests, or another security. Under FINRA Rule 3280, an associated person may not participate in a private securities transaction without first providing the member firm with written notice describing the proposed transaction and the person’s role. If the person will receive selling compensation, the firm must provide written approval before participation and record and supervise the activity as if it were conducted through the firm. These requirements help ensure that the firm can assess conflicts of interest, suitability and disclosure issues, and applicable securities-law obligations. The key point is that assisting with a capital raise for a startup can constitute participation in a securities offering conducted away from the member firm. See FINRA Rule 3280, Private Securities Transactions of an Associated Person and FINRA Regulatory Notice 18-08.

QUESTION NO: 25

A customer enters a sell stop order for ABC at $45 when ABC is trading at $47. Later, ABC trades at $45 and continues falling rapidly. Which of the following statements is true?

A. The order will be cancelled because the market price reached the stop price.

B. The order becomes a market order and may be executed below $45.

C. The order becomes a limit order with a limit price of $45.

D. The order must be executed at exactly $45.

ANSWER: B

Explanation:

A sell stop order becomes a market order when the stock trades at or below the stop price. Therefore, once ABC trades at $45, the order is triggered and seeks immediate execution at the best available market price. In a rapidly declining market, the execution price may be below $45.

The stop price is a trigger price, not a guaranteed execution price. A sell limit order could establish a minimum acceptable price, but it might not execute if the market moves below that limit.

QUESTION NO: 26

Which of the following is the term for a filing for a distribution of securities in which the issuer has up to three years after the effective date of registration to sell the securities?

A. Shelf registration

B. Primary offering

C. Standby underwriting

D. Preliminary registration

ANSWER: A

Explanation:

Shelf registration is correct. A shelf registration statement allows an eligible issuer to register securities with the SEC but defer the actual sale of all or part of those securities until a later time. The issuer can then conduct one or more takedowns from the "shelf" when market conditions or its financing needs are favorable, rather than having to complete the entire distribution immediately after registration becomes effective. For most shelf registration statements, the securities may be offered and sold for up to three years after the registration statement's effective date. Before each takedown, the issuer generally updates the prospectus through a prospectus supplement describing the specific securities, price, and terms of that offering. This mechanism is especially useful for established reporting companies that expect to access the capital markets repeatedly or on short notice. SEC Rule 415 governs delayed or continuous offerings and is the basis for shelf-registration procedures. The SEC's investor materials also describe how companies may register securities for sale on a delayed or continuous basis. See SEC Rule 415 and the SEC's registration statement overview.

QUESTION NO: 27

A public company announces that its chief executive officer has resigned unexpectedly. An investor wants to review the periodic SEC filing generally used to disclose this type of material corporate event. Which filing should the investor review?

A. Form 10-K

B. Form 10-Q

C. Prospectus

D. Form 8-K

ANSWER: D

Explanation:

Form 8-K is generally used to report significant events that occur between periodic reports, including changes in a registrant's principal officers. It provides more timely disclosure than the company's quarterly or annual reports.

Form 10-K is the issuer's comprehensive annual report and includes audited financial statements. Form 10-Q is a quarterly report. A prospectus is used in connection with securities offerings rather than as the regular report for a material corporate event.

QUESTION NO: 28

Which of the following terms refers to the process in which the buying firm must pay for the securities and the selling firm must deliver the securities?

A. Trade execution

B. Corporate action

C. Clearing the trade

D. Settlement of the transaction

ANSWER: D

Explanation:

Settlement of the transaction is the process through which the buyer fulfills its obligation to pay for purchased securities and the seller fulfills its obligation to deliver those securities. It is the final completion of a securities trade: cash is transferred to the seller and securities are transferred to the buyer, generally through the established clearing and depository infrastructure. This exchange is commonly described as delivery versus payment, because delivery of securities and payment of funds are coordinated to reduce the risk that one party performs without receiving the promised consideration.

For most U.S. broker-dealer transactions in covered securities, the standard settlement cycle is one business day after the trade date (T+1), subject to exceptions for particular products or circumstances. The Securities and Exchange Commission adopted the T+1 standard to reduce credit, market, and liquidity risks that can accumulate between execution and settlement. FINRA's educational material similarly distinguishes the completion of a transaction through the delivery of securities and payment of funds as settlement. See the SEC's T+1 settlement-cycle rule release and FINRA's overview of stock investing and trade processing.

QUESTION NO: 29

Under Industry rules, what is the maximum price that qualifies a security as a penny stock?

A. $0.10

B. $0.50

C. $1.00

D. $5.00

ANSWER: D

Explanation:

$5.00 is the correct threshold. For purposes of the federal penny-stock rules, a penny stock generally is an equity security with a price of less than $5 per share, subject to specified exclusions. Thus, $5 is the maximum price threshold used to identify securities that may fall within the penny-stock definition; more precisely, the security's price must be below $5.00. This threshold matters because transactions in penny stocks can trigger additional broker-dealer disclosure and customer-protection requirements, including delivery of a risk disclosure document and transaction-related information in applicable circumstances. The SIE exam commonly tests the $5 threshold as the defining price level for penny stocks. The regulatory definition appears in SEC Rule 3a51-1, while the SEC's investor guidance describes penny stocks as generally trading below $5 per share. See 17 CFR § 240.3a51-1 and the SEC's Microcap Stock: A Guide for Investors.

QUESTION NO: 30

Which of the following statements describes a violation of industry standards of conduct?

A. A firm hires a registered representative (RR) with a 15-year-old felony conviction.

B. An RR ' s cousin purchases shares of an initial public offering (IPO).

C. An RR takes a second job as a bartender without notifying her firm.

D. An RR purchases a stock based on a published research report prepared by her firm.

ANSWER: C

Explanation:

An RR takes a second job as a bartender without notifying her firm is a violation because the job is an outside business activity for which the registered representative expects compensation. FINRA Rule 3270 requires a registered person to provide prior written notice to their member firm before engaging in an outside business activity that is outside the scope of the person's relationship with the firm. This requirement applies even when the activity has no apparent connection to securities, such as working as a bartender.

Prior notice enables the firm to determine whether the activity could interfere with the representative's responsibilities, create an actual or potential conflict of interest, expose the firm to reputational risk, or require additional supervision. The rule does not make every outside job impermissible; rather, it requires disclosure before the activity begins so the firm can assess it and impose limitations or supervision when appropriate. A representative who starts compensated outside employment without providing that notice deprives the firm of its required opportunity to review and supervise the activity, breaching the standard of conduct established by FINRA Rule 3270. See FINRA Rule 3270, Outside Business Activities of Registered Persons and FINRA's Outside Business Activities compliance resource.

QUESTION NO: 31

A registered representative who is terminated from a broker-dealer must notify FINRA of a residential address change for what period of time after termination?

A. One year

B. Two years

C. Three years

D. Six years

ANSWER: B

Explanation:

Two years is correct. Under Article V, Section 3 of FINRA's By-Laws, a person whose association with a FINRA member has terminated must notify FINRA, in the manner FINRA specifies, of any change in residential address for two years following termination. The obligation applies even though the individual is no longer employed or associated with the broker-dealer. It helps FINRA maintain reliable contact information for former registered persons while they remain within FINRA's post-termination jurisdiction and while regulatory matters, customer complaints, investigations, or disciplinary proceedings may arise.

The two-year period is measured from the effective date of the person's termination. Former associated persons generally provide the update through FINRA's established filing process, which allows FINRA to maintain accurate records in the Central Registration Depository system. This is a continuing personal obligation of the terminated representative; it is not dependent on whether the former firm remains able to contact that person. The governing requirement is found in Article V, Section 3 of the FINRA By-Laws. FINRA's guidance on the Uniform Termination Notice for Securities Industry Registration, Form U5, is also available at FINRA Form U5.

QUESTION NO: 32

Which of the following parties has the authority to approve changes to the fundamental investment policy of an investment company?

A. The SEC

B. The shareholders

C. The portfolio manager

D. The chief marketing officer

ANSWER: B

Explanation:

The shareholders is correct. Under the Investment Company Act of 1940, a registered investment company must disclose its fundamental investment policies, which commonly address matters such as borrowing, underwriting, concentration, and investing in particular types of securities or industries. These policies cannot be changed unless the change is authorized by a shareholder vote. This requirement protects investors by ensuring that an investment company cannot materially depart from the investment restrictions and objectives presented to shareholders when they invested without obtaining their approval. For this purpose, the required approval is generally a “majority of the outstanding voting securities,” a defined statutory standard that may be satisfied by a majority of shares present when holders of more than 50% of outstanding voting securities are present, or by more than 50% of all outstanding voting securities, whichever is less. The fund’s board and investment adviser may oversee operations and propose policy changes, but shareholder authorization is necessary for a fundamental-policy amendment. See the Investment Company Act’s provisions on fundamental policies at 15 U.S.C. § 80a-13 and the SEC’s overview of mutual-fund governance and disclosures at SEC: Mutual Funds.

QUESTION NO: 33

After a customer purchases bonds at a yield of 5.00%, the current yield at market price increases to 5.25%. Which of the following statements is true regarding the value of the bonds?

A. The value of the bonds has increased.

B. The value of the bonds has decreased.

C. The face value of the bonds has decreased.

D. There is no change in the value of the bonds.

ANSWER: B

Explanation:

The value of the bonds has decreased. A bond’s current yield equals its annual interest payment divided by its current market price. Because the bond’s coupon payment is fixed, an increase in current yield from 5.00% to 5.25% must result from a decline in the bond’s market price. For example, if a bond pays $50 in annual interest, a $1,000 market price produces a 5.00% current yield; if its market price falls to approximately $952.38, the same $50 payment produces a 5.25% current yield. This reflects the core fixed-income principle that bond prices and yields move in opposite directions. When newly available market yields rise, an existing bond with a fixed coupon generally must trade at a lower price to provide a competitive return to a prospective purchaser. The bond’s stated principal amount at maturity remains fixed, but its value in the secondary market fluctuates with prevailing interest rates, credit conditions, maturity, and other market factors. FINRA identifies the relationship between bond prices, interest rates, and yields as essential fixed-income knowledge for the SIE examination. See FINRA’s Bond Investing overview and the SEC’s Investor Bulletin on Bonds.

QUESTION NO: 34

An associated person at a member firm receives a complaint from a customer involving allegations of forgery. Once the complaint is received, which of the following actions is required?

A. The member firm must report the complaint to FINRA no later than the fifteenth day of the calendar quarter following the quarter in which it received the complaint.

B. The member firm is not required to report the event to FINRA but must maintain a file of the complaint for four years.

C. The member firm must complete arbitration to resolve the complaint with the customer before filing a report with FINRA.

D. The member firm must have a principal review the complaint and determine if the forgery occurred before filing a report with FINRA.

ANSWER: A

Explanation:

The member firm must report the complaint to FINRA no later than the fifteenth day of the calendar quarter following the quarter in which it received the complaint. FINRA Rule 4513 requires firms to maintain written procedures requiring associated persons to promptly report specified customer complaints to the firm. A complaint alleging forgery is one of the specified matters. The firm must then make the required regulatory report under FINRA Rule 4530(a)(1)(G), which covers a written customer complaint alleging theft, misappropriation of funds or securities, or forgery. Importantly, the reporting obligation is triggered by receipt of the qualifying written complaint; the firm does not need to first complete an investigation or establish that forgery actually occurred. Although the associated person must promptly escalate the complaint internally under the firm's procedures, the firm's external filing deadline is the fifteenth day of the next calendar quarter, rather than an undefined requirement to report "promptly" to FINRA. These requirements help FINRA receive timely information about serious allegations involving customer accounts and allow the firm to meet its supervisory and reporting obligations. See FINRA Rule 4513 and FINRA Rule 4530.

QUESTION NO: 35

SIPC provides investor protection for its members ' customers in which of the following situations?

A. Failure of a brokerage firm in the event of insolvency

B. Failure of a brokerage firm to meet customers ' investment expectations

C. Losses greater than 10% due to systemic market decline

D. Losses incurred on futures contracts due to fraud or negligence

ANSWER: A

Explanation:

SIPC protection applies when a SIPC-member broker-dealer fails financially and customer cash or securities are missing from customer accounts. In that situation, SIPC may initiate a liquidation proceeding and works to return customers' property, either by transferring accounts to another financially sound brokerage firm or by satisfying claims within SIPC protection limits. The standard maximum protection is $500,000 per customer, including a maximum of $250,000 for cash claims. SIPC protection is designed to restore the cash and securities that a customer had entrusted to the failed firm; it does not function as insurance against changes in an investment's value. Therefore, *Failure of a brokerage firm in the event of insolvency* correctly identifies the event that triggers SIPC's customer-protection role. A brokerage firm's insolvency alone does not necessarily mean every customer will suffer a loss, since customer assets are generally segregated from the firm's assets, but SIPC is available when a member firm fails and customer property must be recovered and distributed. SIPC's official overview explains both its role in failed brokerage cases and the applicable coverage limits. See SIPC: What SIPC Protects and FINRA's Understanding SIPC Protection.

QUESTION NO: 36

At least how often Is a firm required to provide a customer with a statement In writing as to the availability of an Investor brochure posted on the MSRB website?

(AC?)

A. Monthly

B. Quarterly

C. Annually

D. Once every three years

ANSWER: C

Explanation:

Annually is correct. MSRB Rule G-10 requires a municipal securities dealer to provide written notification, at least once during each calendar year, to certain customers who purchase municipal securities. The notice must state that the MSRB's investor brochure is available on the MSRB website and must provide the website address. This requirement helps ensure that municipal-bond customers receive recurring notice of where they can obtain educational information about municipal securities, including investment considerations and the protections applicable to transactions with municipal securities dealers.

The obligation is an ongoing customer-notification requirement, rather than a one-time disclosure made only when an account is opened or a transaction occurs. A firm may satisfy the written-notice requirement through an appropriate written communication, including an electronic communication where permitted, provided the notice is delivered in a manner consistent with applicable electronic-delivery requirements. The key testing point is the minimum frequency: the notification must be made once per calendar year. See MSRB Rule G-10 and the MSRB's investor resources.

QUESTION NO: 37

Which of the following statements is true about U.S. government agency issues?

A. They pay interest quarterly.

B. They are traded only on the NYSE.

C. They are backed by the full faith and credit of the U.S. government.

D. They usually sell at a higher yield than Treasury securities of equal maturity.

ANSWER: D

Explanation:

"They usually sell at a higher yield than Treasury securities of equal maturity." is correct because agency securities generally have a modest yield spread over comparable U.S. Treasury securities. Treasury securities are direct obligations of the federal government, and the market treats them as having essentially no credit risk. Agency issues are issued by government-sponsored enterprises or federal agencies, and their federal backing differs by issuer. Although certain agency obligations, such as those issued by Ginnie Mae, carry the full faith and credit of the U.S. government, many government-sponsored enterprise obligations do not have that explicit guarantee. Investors therefore commonly require additional yield to compensate for the differing credit, liquidity, call, and structural characteristics of agency issues relative to Treasuries. The word "usually" is important: the pricing relationship is a general market convention, not an absolute rule for every security at every moment. Yield comparisons should be made using securities with similar maturities and comparable features, because embedded call provisions and other terms can also affect an agency bond's yield. FINRA describes agency bonds and their varying federal-support structures at FINRA's Agency Bonds resource. TreasuryDirect explains that marketable Treasury securities are backed by the full faith and credit of the U.S. government at TreasuryDirect.

QUESTION NO: 38

A selling group member in an initial public offering (IPO) has the primary responsibility for which of the following obligations related to the IPO ' s prospectus?

A. Preparing the prospectus

B. Distributing the prospectus to prospective investors

C. Ensuring that the prospectus is filed with the SEC

D. Ensuring that the information in the prospectus is accurate and complete

ANSWER: B

Explanation:

Distributing the prospectus to prospective investors is correct because a selling group member's principal function in an IPO is to participate in the public distribution of the offering. Selling group members receive an allocation of securities from the managing underwriter or syndicate and offer those securities to their customers. In connection with those sales, they must meet applicable prospectus-delivery requirements so that customers have access to the offering disclosure information when making an investment decision.

The Securities Act registration process is designed to provide investors with material information about a registered offering through the prospectus. For broker-dealers participating in the distribution, this means facilitating delivery of, or access to, the final prospectus in the manner permitted by the federal securities laws and SEC rules. Under Securities Act Rule 172, an issuer's filing of the final prospectus with the SEC's EDGAR system may satisfy certain physical-delivery requirements, but a selling group member remains responsible for complying with its obligations when selling the IPO to customers. This distribution-and-delivery role is central to a selling group member's participation in the offering. See the SEC's Rule 172 adopting release and the SEC's overview of registered public offerings.

QUESTION NO: 39

Government National Mortgage Association pass-through certificates pay interest and principal to holders:

A. Monthly

B. Quarterly

C. Semiannually

D. Annually

ANSWER: A

Explanation:

Government National Mortgage Association (GNMA), or Ginnie Mae, pass-through certificates distribute both interest and principal **monthly**. A pass-through certificate represents an ownership interest in a pool of federally insured or guaranteed residential mortgage loans, such as FHA-insured and VA-guaranteed mortgages. Homeowners generally make their mortgage payments each month. Those scheduled payments, including interest and principal repayments, are collected by the mortgage servicer and then passed through to investors, net of applicable servicing and guaranty fees.

This monthly cash-flow feature is fundamental to mortgage-backed pass-through securities. Unlike a conventional bond, where principal is commonly repaid in one lump sum at maturity, a GNMA investor receives principal over the life of the mortgage pool as borrowers amortize their loans. Investors may also receive unscheduled principal payments when borrowers prepay mortgages through refinancing, selling a home, or otherwise paying off their loans early. GNMA guarantees the timely payment of principal and interest on its certificates, and that guaranty is backed by the full faith and credit of the U.S. government. FINRA identifies mortgage-backed securities and their cash-flow and prepayment characteristics as SIE-tested debt-product concepts. See Ginnie Mae—GNMA Securities and FINRA SIE Content Outline.

QUESTION NO: 40

An investor owns 100 shares of a company ' s stock and is very interested in electing a particular individual to the board of directors of the corporation. There are 20 individuals running to fill 10 board seats. If the corporation uses the cumulative voting method, what is the maximum number of votes the investor is permitted to cast for this particular director?

A. 50 votes

B. 100 votes

C. 1,000 votes

D. 2,000 votes

ANSWER: C

Explanation:

1,000 votes is correct. Under cumulative voting, a shareholder receives a number of votes equal to the number of shares owned multiplied by the number of directors to be elected. Here, the investor owns 100 shares and there are 10 available board seats, resulting in 1,000 total votes (100 × 10). Cumulative voting permits the shareholder to distribute those votes among candidates in any manner, including casting every available vote for one particular nominee. Therefore, because the investor is focused on electing a single individual, the maximum number of votes that may be concentrated on that director is 1,000. This voting structure is designed to give minority shareholders a greater opportunity to influence board elections by allowing them to pool their voting power behind a preferred candidate rather than requiring votes to be allocated separately for each open seat. FINRA's SIE content outline includes voting rights and cumulative voting within the equity-securities knowledge tested on the exam. See the FINRA SIE Content Outline and the SEC's Investor Bulletin on Proxy Voting.

QUESTION NO: 41

An investor generally purchases an open-end mutual fund from which of the following parties?

A. The NYSE

B. The fund's custodian

C. The fund's underwriter

D. An existing shareholder

ANSWER: C

Explanation:

The fund's underwriter is correct because open-end mutual funds continuously issue and redeem their own shares. New shares are distributed to investors through the fund's principal underwriter, either directly or through selling dealers and broker-dealers. The purchase price is generally the next computed net asset value (NAV) after the order is accepted, plus any applicable front-end sales charge. This continuous-distribution structure is a defining characteristic of an open-end investment company: its shares are not ordinarily bought and sold among public investors in a secondary market. The underwriter serves as the key distribution intermediary, arranging the sale of newly issued fund shares to the investing public and supporting the fund's ongoing offering process. FINRA's SIE-level investment-company concepts distinguish this primary distribution of open-end fund shares from exchange trading of other securities. The SEC likewise explains that mutual funds sell shares to investors and stand ready to redeem them, with the price based on NAV. See the SEC's Guide to Mutual Funds and FINRA's Mutual Funds overview.

QUESTION NO: 42

Which of the following scenarios may cause a firm to consider placing a registered representative on heightened supervision?

A. A felony arrest but no charge

B. A recent history of customer complaints

C. A recently obtained large home equity line of credit

D. Placement of trades in a discretionary account without first consulting the customer

ANSWER: B

Explanation:

A recent history of customer complaints may cause a firm to consider placing a registered representative on heightened supervision. Under FINRA Rule 3110, each member firm must establish, maintain, and enforce a supervisory system reasonably designed to achieve compliance with securities laws and FINRA rules. That obligation is risk-based: when a representative develops indicators of possible sales-practice concerns, such as a pattern or recent concentration of customer complaints, the firm should evaluate whether enhanced controls are warranted. Heightened supervision can be tailored to the identified risk and may include more frequent review of transactions and correspondence, preapproval of certain activity, increased manager contact, or additional documentation and reporting requirements. Customer complaints are particularly relevant because they can identify potential issues involving recommendations, communications, suitability, account handling, or other conduct affecting investors. The appropriate response depends on the nature, frequency, recency, and outcomes of the complaints, as well as the representative's overall disciplinary and supervisory history; heightened supervision is not automatically required by every complaint. Still, a recent complaint history is a meaningful risk signal that a prudent firm may address through enhanced supervision. See FINRA Rule 3110 (Supervision) and FINRA's Supervision guidance.

QUESTION NO: 43

The prohibited practice of excessively trading in a discretionary account in order to generate commissions is known as:

A. kiting.

B. churning.

C. freeriding.

D. front running.

ANSWER: B

Explanation:

Churning is the prohibited practice of effecting excessive securities transactions in a customer account primarily to generate commissions or other compensation for the broker-dealer or associated person. It commonly arises in a discretionary account because the representative has authority to make trades without obtaining approval for each transaction. However, regulators may also find churning in a nondiscretionary account when the representative exercises de facto control over the customer's trading decisions. The essential concern is that the frequency and volume of trading are unsuitable for the customer's investment objectives, financial circumstances, and account size, while serving the representative's compensation interest rather than the customer's interests. FINRA identifies excessive trading as a potentially manipulative, deceptive, or fraudulent practice and notes that it can violate FINRA rules as well as federal securities laws. In evaluating whether churning occurred, the circumstances of the account and the representative's control over it are important considerations. This conduct undermines the obligation to deal fairly with customers because transaction-based compensation is being prioritized over a strategy reasonably designed for the customer. See FINRA's discussion of excessive trading in FINRA Rule 2111 and the SEC's investor guidance on churning.