

# Series 7 study guide



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## Chapter 13 Investment Company (?????) Investment Companies A

corporation or trust in which investors pool their funds and are usually organized as corporations in the same manner as any other business corporation. However, some have been established as trusts and as such are supervised by trustees rather than directors. Diversification Advantages of Investment Company Professional Management Company Liquidity The basic legislation governing investment company and defines and classifies investment companies into 3 basic types. Face Amount Certificate Company The Investment Company Act of 1940

Unit Investment Trust (UIT) 1940 Management Company The Act requires all investment companies with 100 shareholders or more to register with the SEC. A public offering may not be made by a mutual fund until it has a minimum net worth of \$100,000. New shares are registered by the fund periodically, usually Type of Investment Companies Face Amount Certificate Issues debt certificates offering a predetermined rate of interest. Holders are entitled to redeem their certificates for a fixed amount on a specified date.

Investment companies with no management fee and low sales charges that invest in a fixed Unit Investment Trust portfolio of municipal or corporate bonds are categorized as UIT. The funds are issued in book form (UIT / ?????) entry form and registered form. Established under an indenture or similar agreement, they manage a portfolio of securities in accordance with specified investment objectives. Each day, usually at the end of trading on the NYSE, a management company will determine the value of its Management Company

portfolio or the net asset value (NAV) per share. ? Closed-end ? Does not issue redeemable shares ? Open-end ?

Issues redeemable shares Usually capitalizes through a 1-time public offering of shares and may issue common stock, Closed-end Investment preferred stock, or bonds. The company does not continuously issue shares nor will it redeem its Company shares. The market price of closed-end funds will be based on the f Also called mutual fund. They are continuously issuing new shares which they stand ready to Open-end Investment Company redeem. All shares issued are common shares ONLY. Instead of 5% policy, sales charge will be applied. Management (investment advisory) fees are normally the largest Chapter 13

Types of Mutual Funds Diversified Common Stock Funds Income Funds Balanced Funds Bond Funds Money Market Funds Bonds and Preferred Stock Funds Specialized Funds Operation of a Mutual Fund Board of Directors Investment Companies Consists mostly of common stocks. The funds can have a variety of investment objectives. One might be conservative and invest primarily in blue-chip stocks. Another might be more aggressive and invest primarily in growth stocks. Have as their investment objective high current income. Maintain some proportion of their assets in bonds and preferred stock as well as in common stock.

Invest their assets solely in bonds and have as their objective stability of income. Invest in short-term debt (money market) instruments. A typical money market fund invests in CP and CDs. They generally pay the interest to the investors monthly. Invest in senior securities, both bonds and preferred stock. Their objective is current income with safety of principal.

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Invest a large proportion of their assets in a particular industry such as the chemical industry. Elected by the mutual fund shareholders and are responsible for developing and implementing investment policies.

According to the Investment Company Act of 1940, at least 40% of the board of directors must be unaffiliated with the mutual fund. Unless authorized by majority vote of its shares, an investment company may not; ? Go from diversified to non-diversified ? Change its investment objectives and concentration of investments ? Borrow money, underwrite securities issued by others, make loans, buy or sell real estate ? Change the nature of business so as to cease acting Must be sent to stockholders semiannually. Mutual funds sell ex-dividend whenever the fund or its principal underwriter(sponsor) determines.

The ex-dividend date for a mutual fund is usually the same day as the record date. Contracted by the fund to issue new shares and cancel redeemed shares for the fund. Normally also in charge of the disbursement of dividend and capital gain distributions and performing other bookkeeping. Responsible for the safekeeping of the securities owned by a mutual fund. Mutual funds must have a national bank, trust company or other qualified institution act as its custodian. He holds the cash and securities of the fund but does NOT perform any mana The principal underwriter of the fund.

He has an exclusive agreement with the fund which allows him to purchase fund shares at the current NAV. The shares may then be resold to the public, through outside dealers or the sponsor's sales force, at the full Shareholder Rights Financial Report Dividend of Mutual Fund Transfer Agent Custodian Sponsor(Distributor) Chapter 13 Section 12b-1(The Investment Company Act

of 1940) Investment Companies Though a sponsor is used and bears the cost of sales of literature and other promotional items, under certain situation, selling expenses may be borne by the fund. Chapter 13 Dealers Investment Companies

Must have a signed selling agreement with the sponsor. They are forbidden to purchase mutual fund shares for inventory. But they can do so only to fill customer orders or for their own investment. If a dealer who has purchased shares for investment decides to manage the fund's portfolio. Re. management of a mutual fund, securities on margin, participate in a joint account, or sell short securities may not be permitted in general. Investment advisory contracts must be approved by a majority of the fund's share Total Expense / Average Net Assets NAV + Sales Charge = NAV / (100% - Sales Charge Percentage) = \$10.00 / (100% - 7%) = \$10.75 Total Net Asset / Number of Shares Outstanding Orders to buy and sell the fund are based on the next price to be computed. Sales Charge / Public Offering Price = \$1.57 / \$19.60 = 8% Based on public offering price. According to the NASD's Conduct Rules, the maximum allowable percentage is 8.5%. In the sale, there is no sales charge though there is a redemption fee (i.e. 1%). To charge the maximum 8.5% sales charge, the mutual fund must offer to be sold to the public at the NAV, without any sales charge added. No-load fund may charge a liquidation fee when an investor sells the fund.

Dollar levels at which the sales charge is reduced. Amount Deposited Sales Charge Percentage Less than \$10,000 8.5% \$10,000 - \$25,000 7.5% \$25,000 - \$50,000 6.0% ??? ?????????? Enables an investor to qualify for the discount made available by breakpoints without initially depositing the entire

amount required. LOIs are NOT binding on the investor and only available to single purchaser. The letter states the investor's intention Those people who are eligible for sales breakpoints and LOI, which includes a joint account only between husband and wife.

Partnership, investment clubs and joint accounts are NOT eligible for reduced sales charges or LOI. Investment Advisor Expense Ratio Buying Mutual Fund Shares Public Offering Price(Asked Price) Net Asset Value(NAV / per share) Buy and Sell the Fund Sales Charge Percentage No-load(N. L. ) Funds Breakpoints Letter of Intent(LOI) Single Purchaser Chapter 13 Voluntary Plans Dollar Cost Averaging (Constant Dollar Plan) Dollar Averaging Redeeming Mutual Fund Shares Redemption Investment Companies Require an initial minimum investment.

The investor will indicate an intention to invest a minimum amount at fixed intervals, such as montly or quarterly. Fixed dollar amount is invested periodically. Fixed share amount is invested periodically. Redemption fee is calculated based on NAV. Mutual funds are required under the Investment Company Act of 1940 to pay the proceeds of redemption within 7 calendar days. The SEC can order or allow, upon the request of a fund, that redemption be suspended fo ? Fixed-dollar Types of Withdrawal Plans ? Fixed-percentage ? Fixed-share Taxation of Mutual Fund Distributions Earnings for Investment ?

Investment income(dividends & interest on the securities) Companies ? Capital gain Investors will receive a Form 1099 to report distributions for income tax purpose. They may elect to Form 1099 take distributions from mutual funds in the form of reinvested shares rather than in the form of

cash. Investment Income Dividends & interest on the securities. Taxable to the investors as ordinary income. When an asset is sold for more than its cost, the result is a capital gain. ? Long-term gains ? Result from the sale of assets held for more than 1 year / taxed as capital gain Capital Gain ? Short-term gains ?

Result from the sale of assets held for 1 year or less / taxed as ordinary income Capital gains are taxed at the individual's tax rate, up to a maximum of 20%. Holders of one fund in the group may have an exchange or conversion privilege allowing them to Exchange Privilege convert to another fund of the same manager at the NAV. Investment companies can avoid paying taxes on income since they are eligible for special tax Taxation of Investment treatment under Subchapter M of the Internal Revenue Code. This special tax treatment is called Companies the " conduit" or " pipeline" treatment.

Avoid triple taxation which would occur if the mutual fund paid taxes. The companies held in the fund's portfolio pay corporate income taxes and the investor pays taxes on dividends received from the fund. Therefore, taxes payable on dividends and interest Conduit / Pipeline Chapter 13 Conduit / Pipeline Investment Companies Corporation in Portfolio Mutual Fund Dividend Investors Regulated Investment Companies The investment companies that meet certain requirements under Subchapter M are considered to be regulated investment companies. Chapter 13 Reporting Requirements 300% Asset Coverage

Investment Companies Annual report must be sent to the SEC and semiannual reports must be sent to the shareholders. Investment Company

Rules and Regulations Management companies(open-end & closed-end) are subject to 300% asset coverage to control their leverage, thereby reducing risk. NASD Rules on Investment Companies Selling Fund Shares NASD members may not purchase fund shares at a discount from an underwriter unless the underwriter is also an NASD member. This effectively restricts non-member underwriters from distributing their shares through NASD firms.

NASD members must transmit pay

Applied to the practice of inducing an investor to purchase a mutual fund on the basis of an impending dividend. The investor was induced to buy the stock based on the impending dividend. However, had the investor waited until ex-dividend date, the price occurs when a registered representative does not inform a customer about the availability of a Breakpoint Sale sales breakpoint or a LOI. The Anti-Reciprocal Rule of the Prohibits member firms from selling open-end investment company(mutual fund) shares because NASD of commissions received or to be received from the investment company.

An underwriter of investment company shares is prohibited from giving a member firm any Special Deals discount above the one specified in the selling agreement for the sale of the shares. If a RR retires, he or she may continue to receive commissions for sales of investment company Continuing Commissions periodic payment plans initiated prior to the retirement if there was a bona fide contract with the person's firm to receive such commissions.

Selling Dividends Chapter 13 Investment Companies

Investment Company Advertising and Sales Literature SEC Rule 134 Permits the publication of a simple ad describing the basic features of a new issue.

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Permits the use of ad that describes, in general terms, how investment companies work. The SEC Rule 135A communication must be limited to information re. investment companies in general, or to the nature of investment companies. Permits the publication of an investment company ad that satisfies the definition of a prospectus SEC Rule 482 under certain conditions. This ad may NOT contain an application to invest in the investment company.

SEC Rule 156 Sales Literature Real Estate Investment Trust (REIT) Tax Treatment Difference between Appreciation & Capital Gain Warns that sales literature would be considered misleading if it 1) contained an untrue statement of material fact, 2) omitted a material fact that was necessary to make a statement not misleading. Any sales literature re. redeemable investment company securities must be filed with the SEC within 10 days of use. Similar to an investment company but is not considered to be a type of investment company.

He manages a portfolio of real estate oriented investments to earn profits for investors. To qualify as a REIT, a company must be set up as a domestic corporation. REITs are the favorable tax treatment given under the REIT Act Amendment to the Internal Revenue Code of 1954. If 95% of the ordinary income generated from the portfolio is distributed to investors, REIT is taxed only once. Appreciation : An increase in the market price of a security from the purchase price. Capital Gain : Recognized when the security is sold and the appreciation is realized.