CHAPTER 6

Mutual Funds

INTRODUCTION

We examined many of the different types of securities that an investment company may purchase in order to achieve its objectives. In this chapter, we will look at how an investment company pools investors' funds in order to purchase a diversified portfolio of securities. It is imperative that all candidates have a complete understanding of how an investment company operates. Some of the test focus points will be on:

- Types of investment companies
- Investment company structure
- Investment company registration
- Investment company taxation
- Investment strategies and recommendations
- Investor benefits

INVESTMENT COMPANY PHILOSOPHY

An investment company is organized as either a corporation or as a trust. Money from individual investors is then pooled together into a single account and used to purchase securities that will have the greatest chance of helping the investment company reach its objectives. All investors jointly own the portfolio that is created through these pooled funds, and each investor has an undivided interest in the securities. No single shareholder has any right or

claim that exceeds the rights or claims of any other shareholder, regardless of the size of the investment. Investment companies offer individual investors the opportunity to have their money managed by professionals who may otherwise only offer their services to large institutions. Through diversification, the investor may participate in the future growth or income generated from the large number of different securities contained in the portfolio. Both diversification and professional management should contribute significantly to the attainment of the objectives set forth by the investment company. There are many other features and benefits that may be offered to investors that will be examined later in this chapter.

TYPES OF INVESTMENT COMPANIES

All investment company offerings are subject to the Securities Act of 1933, which requires the investment company to register with the Securities and Exchange Commission (SEC) and to give all purchasers a prospectus. Investment companies are also all subject to the Investment Company Act of 1940, which sets forth guide lines on how investment companies operate. The Investment Company Act of 1940 breaks down investment companies into three different types:

1. Face-amount company (FAC)
2. Unit investment trust (UIT)
3. Management investment company (mutual fund)

FACE-AMOUNT COMPANY/FACE-AMOUNT CERTIFICATES

An investor may enter into a contract with an issuer of a face-amount certificate to contract to receive a stated or fixed amount of money (the face amount) at a stated date in the future. In exchange for this future sum, the investor must deposit an agreed upon lump sum or make scheduled installment payments over time. Face-amount certificates are rarely issued these days, because most of the tax advantages that the investment once offered have been lost through changes in the tax laws.

UNIT INVESTMENT TRUST (UIT)

A unit investment trust (UIT) will invest either in a fixed portfolio of securities or in a nonfixed portfolio of securities. A fixed UIT will traditionally invest in

a large block of government or municipal debt. The bonds will be held until maturity, and the proceeds will be distributed to investors in the UIT. Once the proceeds have been distributed to the investors, the UIT will have achieved its objective and will cease to exist. A nonfixed UIT will purchase mutual fund shares in order to reach a stated objective. A nonfixed UIT is also known as a contractual plan. Both types of UITs are organized as trusts and operate as a holding company for the portfolio. UITs are not actively managed, and they do not have a board of directors or investment advisers. Both types of UITs issue units or shares of beneficial interest to investors that represent as undivided interest in the underlying portfolio of securities. UITs must maintain a secondary market in the units or shares to offer some liquidity to investors.

MANAGEMENT INVESTMENT COMPANY (MUTUAL FUND)

A management investment company employs an investment adviser to manage a diversified portfolio of securities designed to obtain its stated investment objective. The management company may be organized as either an open-end company or as a closed-end company. The main difference between an open-end company and a closed-end company is how the shares are purchased and sold. An open-end company offers new shares to any investor who wants to invest. This is known as a continuous primary offering. Because the offering of new shares is continuous, the capitalization of the open-end fund is unlimited. Stated another way, an open-end mutual fund may raise as much money as investors are willing to put in. An open-end fund must repurchase its own shares from investors who want to redeem them. There is no secondary market for open-end mutual fund shares. The shares must be purchased from the fund company and redeemed to the fund company. A closed-end fund offers common shares to investors through an initial public offering (IPO), just like a stock. Its capitalization is limited to the number of authorized shares that have been approved for sale. Shares of the closed-end fund will trade in the secondary market in investor-to-investor transactions on an exchange or in the over-the-counter market (OTC), just like common shares.

OPEN-END VS. CLOSED-END FUNDS

Although both open-end and closed-end funds are designed to achieve their stated investment objective, the manner in which they operate is different. The following is a side-by-side comparison of the important features of both

open-end and closed-end funds and shows how those features differ between the fund types.

Feature	Open End	Closed End
Capitalization	Unlimited continuous primary offering	Single fixed offering through IPO
Investor may purchase	Full and fractional shares	Full shares only
Securities offered	Common shares only	Common and preferred shares and debt securities
Shares are purchased and sold	Shares are purchased from the fund company and redeemed to the fund company	Shares may be purchased only from the fund company during IPO then secondary market transactions between investors
Share pricing	Shares are priced by formula NAV + SC = POP	Shares are priced by supply and demand
Shareholder rights	Dividends and voting	Dividends, voting, and preemptive

DIVERSIFIED VS. NONDIVERSIFIED

Investors in a mutual fund will achieve diversification through their investment in the fund. However, in order to determine if the fund itself is a diversified fund the fund must meet certain requirements. The Investment Company Act of 1940 has laid out an asset allocation model that must be followed in order for the fund to call itself a diversified mutual fund. It is known as the 75-5-10 test, and the requirements are as follows:

75%—75% of the fund's assets must be invested in securities of other issuers. Cash and cash equivalents are countered as part of the 75%. A cash equivalent may be a T-bill or a money market instrument.

5%—The investment company may not invest more than 5% of its assets in any one company.

10%—The investment company may not own more than 10% of any company's outstanding voting stock.

EXAMPLE

The XYZ fund markets itself as a diversified mutual fund. It has $10,000,000,000 in net assets, and the investment adviser thinks that the ABC Company would be a great company to acquire for $300,000,000. Because XYZ markets itself

as a diversified mutual fund, it would not be allowed to purchase the company even though the price of $300,000,000 would be less than 5% of the fund's assets. The investment company must meet both the diversification requirements of 5% of assets and 10% of ownership in order to continue to market itself as a diversified mutual fund.

INVESTMENT COMPANY REGISTRATION

Investment companies are regulated by both the Securities Act of 1933 and by the Investment Company Act of 1940. An investment company must register with the SEC if the company operates to own, invest, reinvest, or trade in securities. A company must also register with the SEC as an investment company if the company has 40% or more of its assets invested in securities other than those issued by the U.S. government or one of the company's subsidiaries.

REGISTRATION REQUIREMENTS

Before an investment company may register with the SEC, it must meet certain minimum requirements. An investment company may not register with the SEC unless it has the following:

- Minimum net worth of $100,000.
- At least 100 shareholders.
- Clearly defined investment objectives.

An investment company may be allowed to register without having 100 shareholders and without a net worth of $100,000 if it can meet these requirements within 90 days.

Investment companies must file a full registration with the SEC before the offering becomes effective. The investment company is considered to have registered when the SEC receives its notice of registration. The investment company's registration statement must contain:

- The type of investment company (open-end, closed-end, etc.).
- Biographical information on the officers and directors of the company.
- Name and address of each affiliated person.

- Plans to concentrate investments in any one area (i.e., sector fund).
- Plans to invest in real estate or commodities.
- Borrowing plans.
- Conditions under which investment objective may be changed through a vote of shareholders.

Once registered the investment company may:

- Raise money through the sale of shares.
- Lend money to earn interest.
- Borrow money on a limited basis.

An investment company obtains its investment capital from shareholders through the sale of shares. Once it's operating, it may lend money to earn interest, such as by purchasing bonds or notes. An investment company, however, may not lend money to employees. An investment company may borrow money for such business purposes as to redeem shares. If the investment company borrows money it must have $3 in equity for every dollar that it wants to borrow. Another way of saying that is that the investment company must maintain an asset-to-debt ratio of at least 3:1 or of at least 300%.

An investment company is prohibited from:

- Taking over or controlling other companies.
- Acting as a bank or a savings and loan.
- Receiving commission for executing orders or for acting as a broker.
- Continuing to operate with less than 100 shareholders or less than $100,000 net worth.

Unless the investment company meets strict capital and disclosure requirements, it may not engage in any of the following:

- Selling securities short.
- Buying securities on margin.
- Maintaining joint accounts.
- Distributing its own shares.

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Regardless of the makeup of its investment holdings, all of the following are exempt from the registration requirements of an investment company:

- Broker dealers
- Underwriters
- Banks and savings and loans
- Mortgage companies
- Real estate investment trusts (REITs)
- Security holder protection committees

INVESTMENT COMPANY COMPONENTS

Investment companies have several different groups that serve specialized functions. Each of these groups plays a key role in the investment company's operation. They are:

- The board of directors
- The investment adviser
- The custodian bank
- The transfer agent

BOARD OF DIRECTORS

Management companies have an organizational structure that is similar to that of other companies. The board of directors oversees the company's president and other officers who run the day-to-day operations of the company. The board and the corporate officers concern themselves with the business and administrative functions of the company. They do not manage the investment portfolio. The board of directors:

- Defines investment objectives.
- Hires the investment adviser, custodian bank, and transfer agent.
- Determines what type of funds to offer (i.e., growth, income, etc.).

The board of directors is elected by a vote of the shareholders. The Investment Company Act of 1940 governs the makeup of the board. The Investment

Company Act of 1940 requires that at majority or at least 51% of the board be noninterested persons. A noninterested person is a person whose only affiliation with the fund is as a member of the board. Therefore, a maximum of 49% of the board may hold another position within the fund company or may otherwise be interested in the fund. An affiliated person is anyone who could exercise control over the company, such as an accountant. An affiliated person may also include:

- Broker dealer
- Attorney
- Immediate family of an affiliated person
- Anyone else the SEC designates

Both affiliated and interested parties are prohibited from selling securities or property to the investment company or any of its subsidiaries. Anyone who has been convicted of any felony or securities-related misdemeanor or who has been barred from the securities business may not serve on the board of directors.

INVESTMENT ADVISER

The investment company's board of directors hires the investment adviser to manage the fund's portfolio. The investment adviser is a company, not a person, that must also determine the tax consequences of distributions to shareholders and ensure that the investment strategies are in line with the fund's stated investment objectives. The investment adviser's compensation is a percentage of the net assets of the fund, not a percentage of the profits, although performance bonuses are allowed. The investment adviser's fee is typically the largest expense of the fund, and the more aggressive the objective, the higher the fee. The investment adviser may not borrow from the fund and may not have any securities-related convictions.

CUSTODIAN BANK

The custodian bank or the exchange member broker dealer that has been hired by the investment company physically holds all of the fund's cash and securities. The custodian holds all of the fund's assets for safekeeping and provides other bookkeeping and clerical functions for the investment company, such as maintaining books and records for accumulation plans for investors. All

fund assets must be kept segregated from other assets. The custodian must ensure that only approved persons have access to the account and that all distributions are done in line with SEC guidelines.

TRANSFER AGENT

The transfer agent for the investment company handles the issuance, cancellation, and redemption of fund shares. The transfer agent also handles name changes and may be part of the fund's custodian or a separate company. The transfer agent receives an agreed upon fee for its services.

MUTUAL FUND DISTRIBUTION

Most mutual funds do not sell their own shares directly to investors. The distribution of the shares is the responsibility of the underwriter. The underwriter for a mutual fund is also known as the sponsor or distributor. The underwriter is selected by the fund's board of directors and receives a fee in the form of a sales charge for the shares it distributes. As the underwriter receives orders for the mutual fund shares, it purchases the shares directly from the fund at the net asset value (NAV). The sales charge is then added to the NAV as the underwriter's compensation. This process of adding the sales charge to the NAV is responsible for the mutual fund pricing formula, which is NAV + SC = POP.

The underwriter may purchase shares from the mutual fund only to fill customer orders. It may not hold mutual fund shares in inventory in anticipation of receiving future customer orders.

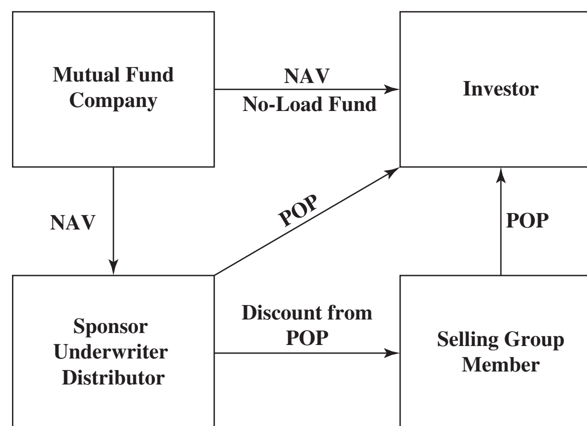
SELLING GROUP MEMBER

Most brokerage firms maintain selling agreements with mutual fund distributors, which allows them to purchase mutual fund shares at a discount from the public offering price (POP). Selling group members may then sell the mutual fund shares to investors at the POP and earn part of the sales charge. In order to purchase mutual fund shares at a discount from the POP, the selling group member must be a member of FINRA. All non-FINRA members and suspended members must be treated as members of the general public and pay the public offering price.

DISTRIBUTION OF NO-LOAD MUTUAL FUND SHARES

No-load mutual funds do not charge a sales charge to the investors who invest in the mutual fund. Because there is no sales charge, the mutual fund may sell the shares directly to investors at the NAV.

DISTRIBUTION OF MUTUAL FUND SHARES



MUTUAL FUND PROSPECTUS

The prospectus is the official offering document for open-end mutual fund shares. The prospectus must be presented to all purchasers of the fund either before or during the sales presentation. The prospectus is the fund's full disclosure document and provides details regarding:

- Fund's investment objectives
- Sales charges
- Management expenses
- Fund services
- Performance data for the past one, five, and 10 years, or for the life of the fund

The prospectus, which is given to most investors, is the summary prospectus. Investors who want additional information regarding the mutual fund may request a statement of additional information. The statement of