

shares at prices below those stated in the fund prospectus could have his broker-dealer registration revoked by the Commission.⁸⁵

5. *Conclusions and recommendations*

In 1940 the Commission was of the opinion that the sales load question should be left "for the present, at least, * * * to competition among the different distributors."⁸⁶ The growth and size of the industry have now reached the point where a reexamination of this question is necessary. More than a quarter of a century of experience shows that the sort of competition which in fact generally prevails, i.e., competition among principal underwriters for the favor of retail dealers rather than price competition among retail dealers, has had the effect of raising rather than lowering prices to the investor. This reflects the industry view that mutual fund shares are sold, not bought. Retail dealers in and salesmen of fund shares are viewed as the key figures in the distribution process. Most fund managers believe that to achieve maximum sales of new shares they must make the sales loads on such shares as attractive as they possibly can—not to the investors who buy them but to the dealers and salesmen who sell them.

Competition of this type has resulted in mutual fund sales charge levels which are far in excess of those investors pay to acquire other types of securities. The costs of investing in securities through the medium of load funds amount to nearly 10 percent of the amount invested.⁸⁷ In the Commission's view the sales charges bear no reasonable relationship to the cost of investing in other types of securities.

The failure of competition among principal underwriters to bring price benefits to mutual fund investors is in part attributable to the retail price maintenance provisions of section 22(d). In a freely competitive market the load-raising effects of the vigorous competition among principal underwriters for the favor of dealers and salesmen could be restrained by countervailing downward pressures stemming from price competition among retailers for investor patronage. By precluding price competition at the retail level, section 22(d) suppresses the downward pressures that normal market forces might otherwise exert.

Because of section 22(d), the investor who is already convinced of the investment merits of mutual fund shares and has already decided to buy a particular fund's shares must—if he chooses a load rather than a no-load fund—pay sales charges designed to cover selling efforts that he does not want, does not need, and does not get. Similarly, the retail dealer who seeks to expand the volume of his business in the traditional free enterprise way by **selling** fund shares at lower prices cannot do so.

The disparity between the prevailing level of compensation for selling mutual fund shares and the prevailing level of sales compensation for other securities has consequences which extend beyond the matter of costs to mutual fund investors. These disparities lead securities firms and their salesmen to recommend and sell mutual fund shares rather than other shares. While mutual fund shares are a

⁸⁵ On broker-dealer registration generally, see pp. 61 and 63, *supra*. The Commission, after notice and opportunity for hearing, may revoke the registration of a brokerdealer and impose sanctions upon persons associated with the firm if it finds, among other things, that there has been a willful violation of any provision of the Investment Company Act.

⁸⁶ Senate Hearings 290.

⁸⁷ See p. 205, *supra*.

valuable medium for equity investment, they are not, under all circumstances and for all persons, the only desirable medium; and it is in the public interest that securities firms and their salesmen, insofar as possible, present varying investment opportunities to their customers without their judgment as to what is best for the particular customer being unduly influenced, perhaps subconsciously, by major differences in sales compensation. Furthermore, some degree of equalization in the level of compensation for selling different types of securities may, without deterring the active sale of mutual fund shares by dealers, avoid a possible distortion of investment decisions and a resulting impact upon the functioning of the markets for reasons extraneous to relative investment merit.

For all these reasons the Commission has concluded that mutual fund sales charges should be lowered.

The Commission has considered achieving this objective by proposing an amendment to the retail price maintenance provisions of section 22(d) so as to remove the barrier to retail price competition in the sale of mutual fund shares. This would enable retail dealers to attract customers by offering lower prices. Such a proposal could be coupled with a prohibition against principal underwriters that distribute fund shares through independent dealers refusing to deal with retailers because the retailers sell shares at prices below a maximum offering price stated in the prospectus. And to prevent discrimination against small dealers or favoritism to dealers who chiefly sell their fund shares, principal underwriters could be precluded from selling fund shares at different prices to different dealers.

The advantages of such a step would be that:

- (1) It is in the competitive, free enterprise tradition; and
- (2) It would allow the proper level of sales loads to be determined by the freely acting forces of retail price competition.

The possible disadvantages of such a step are:

(1) The introduction of free competition might at least temporarily favor captive organizations that are the sole distributors of the fund shares they sell. While indirect competition resulting from public awareness of lower sales charges for shares of other mutual funds would in all probability eventually force captive organizations to reduce their prices, captive organizations would for a time enjoy an unwarranted disparity in sales compensation. They might be able to attract salesmen away from independent dealers who would be subject to direct price competition. Many principal underwriters might abandon distribution through independent dealers in favor of captive sales organizations. Thus, if the Act be amended to permit price competition in the sale of mutual fund shares, the Commission should be authorized to adopt rules designed to bring the captives' charges into line with sales charges paid by purchasers of dealers' distributed fund shares.

(2) Retail price competition would permit knowledgeable investors to purchase mutual fund shares at sales loads substantially lower than those now prevailing, but others—among them those most in need of protection—might save little or nothing. This disadvantage is mitigated by the likelihood that dealers, rather than risking their good business reputation, would charge the same prices to all of their customers who invest the same amount in shares of a particular fund.

These disadvantages could be avoided by establishing permissible maximum loads. A fixed maximum would lower the sales charges paid by nearly all mutual fund investors and would give no competitive advantage—even temporarily—to captive sales organizations over independent dealers. Moreover, the mutual fund industry has operated for over a quarter of a century under the anticompetitive protection against price competition afforded by section 22(d). A maximum sales load would avoid any unsettling and unforeseeable effects which abolition of retail price maintenance might have on the broker-dealer community and would, at the same time, reduce the disparity between the sales charges that investors pay for mutual fund shares and those that they pay for other securities.

Accordingly, the Commission recommends that the Act be amended to provide that—

(1) Sales charges for mutual fund shares may not exceed 5 percent of their net asset value at the time of sale.

(2) The Commission be given express authority to vary the statutory maximum by rule or regulation, or, after notice and opportunity for hearing, by order.

The 5 percent maximum would result in substantial reductions in the sales charges currently paid by mutual fund investors. Yet the permitted compensation for selling effort would still exceed the sales charges investors pay to acquire other securities in almost all transactions. Some may think a 5 percent sales charge too high, especially in view of the continued prohibition of price competition. In the Commission's view the most feasible alternative to such a maximum is to permit retail sales charge levels to be determined by free competitive forces.

Under the proposed rulemaking authority, the Commission could provide for discounts for quantity purchases of mutual fund securities so as to reduce the disparity that would remain—even with a 5 percent sales charge maximum—between mutual fund sales charges and charges for purchases of other securities when relatively large sums of money are involved. The Commission also could vary the maximum sales loads established by statute or rule when necessary or appropriate in the public interest and consistent with the protection of investors.

The above proposal also contemplates that sales charges will be calculated as a percentage of the amount invested in the fund, the usual method of calculating sales charges in the securities industry, rather than as a percentage of the offering price. This method of computation would enable investors to compare more easily the sales charges for fund shares with the charges for buying other securities.

Finally, the Commission also recommends that section 22(c) be amended to empower the Commission to ban anomalous practices, such as loads on investments of dividends, which result in inequitable charges to investors.

G. CONTRACTUAL PLANS

1. Introduction

Many investors buy mutual fund shares on a periodic or installment basis by investing relatively small amounts of money at monthly or other periodic intervals. The two types of installment programs for purchasing fund shares are commonly referred to as "the voluntary plan" and "the contractual plan."

The voluntary plan is a relatively simple arrangement for accumulating shares of a particular mutual fund and provides for a series of purchases over a specified period of time. Typically, only the sales load normally charged for purchases of that fund's shares—usually 8.5 percent—is deducted from the amount of each purchase.

Contractual plans are more complex. Their distinguishing and most important feature is their sales load arrangements. Aggregate sales loads paid by contractual plan investors who complete their plans are about the same as those paid by other purchasers of load fund shares. However, one-half of the planholder's first 12 monthly payments or their equivalent usually is deducted for the sales load. This feature is known as the "front-end load." On installments subject to the front-end load investors pay a sales charge which is about *six* times as much as they would pay on the same investment in the same mutual fund through either "lump sum" or voluntary plan purchases at normal sales load levels.

Contractual plans for selling mutual fund securities were first offered to the public in 1930. **Only** five companies offered them in that year. By 1936 over 40 companies were doing so. The Commission's Investment Trust Study found that many problems existed respecting such plans—then commonly referred to as "installment investment" or "periodic payment" plans. That study focused particular attention on selling practices and excessive sales charges. Total loading charges on completed contractual plans averaged 13.39 percent and in some cases amounted to 20 percent of the amount to be invested. All or most of the first year's payments usually were deducted for sales load and other charges, leaving the plan purchaser with little or no net investment during the first year. Some plans provided for payments of as little as \$5 a month, and a relatively large proportion of purchasers in that category sustained heavy losses through early redemptions.⁸⁸

These were among the abuses that led to the enactment of section 27 of the Act,⁸⁹ which, among other things, limits the sales load to 9 percent of the total proposed payments on contractual plans (the only class of equity securities for which Congress has specified a maximum sales charge). The section also limits the rate at which this sales charge can be deducted from the purchaser's payments to no more than 50 percent on the first 12 installments or their equivalent.

Following the passage of the Act in 1940, sales of contractual plans declined, and all but 5 of the 40 companies then selling such plans abandoned this phase of the securities business. A significant increase in contractual plan sales did not take place until the early 1950's. Since then there has been a marked resurgence of the contractual plan method of selling mutual fund shares. This revival has been stimulated by the generally rising levels of equity security prices, by aggressive selling, and by the increased interest of retail dealers in the front-end sales load. At the end of 1965 the shares of more than 60 mutual funds, including some—but by no means all—of the oldest and largest in the country, could be purchased through contractual plans.

Before 1955, contractual plans were sold, almost without exception, by captive sales organizations maintained by principal underwriters

⁸⁸ See Investment Trust Study, *Supplemental Report on Companies Sponsoring Installment Investment Plans*, H.R. Doc. No. 482, 76th Cong., 3d sess. (1940) 47-107, 185-189.

⁸⁹ See Senate Report 8-10.

of the plans. Since then a considerable number of new contractual plans have been offered for retail distribution through independent dealers. While a majority of contractual plan companies now utilize independent dealers, captive sales organizations continue to account for most of the dollar volume of contractual plan sales. During 1964 about 15 of these organizations accounted for two-thirds of new contractual plan sales. At the end of that year all such organizations accounted for an estimated three-quarters of all payments made on all outstanding contractual plans and for an estimated two-thirds of all payments scheduled to be made on such plans.⁹⁰

At the end of September 1949, investors owned 26,000 contractual plan accounts. They provided for payments totaling \$93 million, one-third of which had been paid.⁹¹ By the end of 1965, there were about 1.3 million contractual plan accounts⁹² which provided for payments totaling \$7.3 billion, of which \$3.1 billion had been paid.⁹³ The net asset value of all contractual plan companies at June 30, 1966, was \$3.5 billion or 9.1 percent of the mutual fund industry's \$38.2 billion net assets.⁹⁴ Conservatively estimated, however, contractual planholders account for more than one-fourth of the 3.5 million mutual fund investors.⁹⁵

The sale of front-end load plans is prohibited or sharply limited in four States—Illinois, Ohio, Wisconsin, and California.⁹⁶ Nevertheless, California accounts for more mutual fund sales—on both a total and a per capita basis—than any other State.⁹⁷

In contrast, all States permit the sale of voluntary plans. The popularity of the voluntary plan, which was first sold in 1950, has been growing rapidly. As of mid-1960 there were an estimated 670,000 voluntary plans in force (51 percent of all accumulation plans), as contrasted with an estimated 638,000 contractual plans (49 percent of all accumulation plans). At the end of 1965, the number of voluntary plans had grown to an estimated 1.4 million⁹⁸ or 52 percent of all accumulation plans.

The great majority of mutual funds—220 (including 36 no-load funds) of the 242 listed in one mutual fund compilation⁹⁹—offered voluntary plans for the accumulation of their shares in 1965. The shares of 182 of these 242 funds are not offered through contractual plans. The shares of 53 funds may be purchased on an installment

⁹⁰ Source: Investment Company Institute.

⁹¹ Association of Mutual Fund Plan Sponsors, Inc., *The Origin and History of the Contractual Plan* ("Origin and History") 10 (1960).

⁹² Source: Association of Mutual Fund Plan Sponsors, Inc. Contractual plan companies also reported having an additional 227,000 single payment plan-accounts.

⁹³ Source: Association of Mutual Fund Plan Sponsors, Inc. Single payment plans (defined in note 104, on p. 226, *infra*) as well as installment payment plans are included in these payments figures.

⁹⁴ The Investment Company Institute estimates that during the years 1960-65, contractual accumulation plans have accounted for from 8.1 percent (in 1965) to 11.8 percent (in 1962) of capital inflow to the mutual fund industry. These figures exclude capital inflow from the reinvestment of capital gains distributions, and for contractual plans do not take into account reinvested income dividends.

⁹⁵ The Investment Company Institute has estimated that at the end of 1965 the 6.7 million shareholder accounts reported to it by member companies were owned by 35 million shareholders. Even allowing for substantial duplication among the 13 million contractual plan accounts—representing those persons who simultaneously make payments on two or more uncompleted contractual plans—it appears that more than 25 percent of the estimated 5 million fund shareholders have invested through contractual plans.

⁹⁶ See Special Study, pt. 4, 168-169. Several other States, including Kansas, Massachusetts, and North Dakota, require that contractual plan purchasers be advised that they have a right to redeem their contractual plan certificate within 30 days of the initial payment and to receive a total refund of it. This refund privilege also is offered to purchasers in other States by plan sponsors who are members of the Association of Mutual Fund Plan Sponsors, Inc., which has adopted this requirement in its Code of Ethical Business Conduct.

⁹⁷ Source: Investment Company Institute.

⁹⁸ Source: Investment Company Institute.

⁹⁹ Arthur Wiesenberger & Co., *Mutual Funds Charts and Statistics*, 1966.

basis through either contractual or voluntary plans, and the shares of another 7 are available through contractual plans but not through voluntary plans.¹⁰⁰

2. Profile of the contractual plan

(a) Structure

The securities commonly known as contractual plans and referred to in the Investment Company Act as "periodic payment plan certificates"¹⁰¹ are issued by investment companies of the unit trust type¹⁰² ("contractual plan companies"). With a few exceptions, the portfolios of these contractual plan companies consist solely of the shares of a particular underlying mutual fund.¹⁰³ These certificates are securities "providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds for such payments."¹⁰⁴

Holders of contractual plan certificates ("contractual planholders") obtain portfolio diversification and professional investment management just as other mutual fund investors do. Contractual planholders, however, get those benefits indirectly—through the plan company's underlying mutual fund shares—rather than from the plan company itself. When the plan companies buy shares of their underlying mutual funds, they pay no sales load.¹⁰⁵ No advisory fee is charged by the sponsor of the contractual plan company, but such a fee is charged by the adviser of the underlying fund and is, in effect, paid by the contractual planholder.

While contractual planholders do not directly own the underlying securities purchased with the proceeds of payments, each planholder has a beneficial pro rata interest in the plan company's portfolio. When the planholder redeems his certificate, he may receive the cash value of his pro rata interest or, at his option, shares of the underlying fund equivalent to his pro rata interest. This interest is recorded on each planholder's account in terms of the number of whole and fractional shares of the underlying mutual fund, and accretions thereon, acquired with the proceeds of his payments after deduction of the sales load and other charges.

The plan company must deposit the underlying securities with a qualified bank which serves as trustee or custodian. The custodian bank holds the funds received for investment, the underlying securities purchased with such funds and the income upon and accretions to

¹⁰⁰ On June 30, 1966, 90 contractual plan companies with total net assets of \$3.5 billion were registered with the Commission.

¹⁰¹ Act, secs. 2(a)(26), 27. They are also known as "periodic payment plans," "installment investment plans" and "systematic accumulative plans."

¹⁰² See p. 38, supra.

One contractual plan company formed prior to the passage of the Act is of the management type (Commonwealth Fund Indenture of Trust Plan A and Plan B). Another management company which issues periodic payment plan certificates is Insurance Securities Trust Fund. See pp. 204-205, supra. Its certificates, however, are not front-end loaded.

¹⁰³ Three contractual plan companies invest equal portions of the proceeds from the sale of plan certificates in specified equity securities. Since management discretion is completely eliminated, investors in these plans pay no advisory fee of any sort. These three companies are pure unit trusts.

¹⁰⁴ Act, sec. 2(a)(26). This section further defines periodic payment plan certificates so as to include other securities issued by the contractual plan company the holders of which have substantially the same rights and privileges as persons who have completed all payments on those of the issuer's securities which provide for a series of periodic payments. Single payment plans, falling within this definition, are usually also issued by contractual plan companies. They are usually sold in denominations of \$500 and up. Since single payment plans are sold at normal sales loads, they are not discussed in this chapter. Statistics presented in this report with respect to contractual plan investment do not include single payment plans unless otherwise noted.

¹⁰⁵ See rule 22d-1(f) under sec. 22(d) of the Act (17 C.F.R. sec. 270.22(d)-1(f)).

them.¹⁰⁶ It also provides administrative and bookkeeping services. The custodian's compensation comes from a service fee, deducted from the planholders' monthly payments. Generally, this ranges from 1 to 3 percent of each payment. If a planholder ceases to make payments, the custodian normally deducts its fee from the planholder's pro rata portion of the plan's income or, if that is insufficient, from his pro rata portion of the plan's capital.

The contractual plan company is a legal entity—in the nature of an escrow or a stakeholding device—which is distinct from its underlying fund. It must register separately with the Commission as an investment company; its periodic payment plan certificates must be registered under the Securities Act of 1933; and the purchasers of these certificates must receive a plan prospectus. Since the offer of a contractual plan certificate also constitutes an offer of the underlying fund's shares, the Securities Act requires that, the underlying fund's prospectus also be delivered to investors.”¹⁰⁷

(b) Distribution

The contractual plan company is almost always established or created by an organization, known as the “plan sponsor,” which acts as the plan company's principal underwriter. As noted, some plan sponsors sell exclusively through their own retail sales forces; others act only as wholesale distributors who utilize a large number of independent dealers to retail the plan certificates, and some plan sponsors combine these two methods of distribution in varying degrees.

For some plan sponsors the expectation of profit from the sale of plan certificates furnishes their primary financial motive for establishing the plan companies. Most plan sponsors, however, are also the principal underwriter of their plan's underlying mutual fund and are affiliated with that fund's investment adviser. Proceeds of plan payments invested in shares of the underlying fund increase that fund's net assets and the advisory income flowing to its adviser. Because of the potential for increased revenue from advisory fees, a few funds sell shares at net asset value to contractual plan companies sponsored by firms unaffiliated with the fund's own adviser-underwriter.¹⁰⁸

(c) Operation or mechanics of the contractual plan

(i) Goal and schedule.—Contractual plans have been described as formal plans because they provide for a goal of investing a specified amount of money over a long, fixed period, ranging from 5 to 25 years, and a schedule of uniform monthly or other periodic payments to achieve that goal. Over two-thirds of the plans provide for payments to be made over 10 years, and the second most frequent period is 12½ years.¹⁰⁹ Most typical is the plan certificate which provides for investing \$3,000 by making monthly payments of \$25 over a 10-year period.

At the time the investor purchases the certificate, he determines how much he expects to invest each month. Plans are available which provide for monthly payment units ranging from as much

¹⁰⁶ Act, secs. 26(a) (1), (2), (3), and 27(c).

¹⁰⁷ See rule 140 under the Securities Act (17 C.F.R. sec. 230.140).

¹⁰⁸ See rule 22d-1(f) under the Act (17 C.F.R. sec. 270.22d-1)(f).

¹⁰⁹ At least 11 contractual plan companies' certificates provide for payments over a 12½ year period. See Arthur Wiesenberger & Co., *Investment Companies* (1966 ed.) 133.

as \$2,000 to as little as \$10, the minimum payment permitted by the Act.¹¹⁰ A majority of contractual plans provide for minimum monthly payments of \$20 or \$25. The Special Study found that the \$25 per month payment unit was most common and that only one out of every ten certificates called for payments of more than \$50 per month.¹¹¹ Most contractual plan companies require an initial payment which amounts to two monthly payment units.¹¹²

Although the commonly used shorthand designations such as "contractual" plan and "periodic" or "systematic" investment plan suggest an obligation on the purchaser to adhere to the payments goal and schedule provided by the plan, the primary "contractual" obligations created by the plan certificates fall on the sponsors and on the custodians.¹¹³ The planholder has no obligation to make any given number of payments. He can always redeem his plan certificate and obtain his full pro rata share of the plan company's underlying securities or the cash value of that share. Nor is the planholder required to adhere to the payments schedule. He is always free to miss scheduled payments or to accelerate them. Indeed initial pre-payments and subsequent acceleration of payments are encouraged, and planholders who are delinquent in making payments, or who cease payments altogether, continue to have credited to their accounts dividends and capital gains distributions on mutual fund shares already paid for. Although a delinquent planholder's failure to make a payment for 12 consecutive months usually entitles the sponsor or custodian to redeem the plan certificate after 30 or 60 days' written notice, it has not been the general practice of plan companies to exercise this option. Thus a 10-year plan may be completed over a longer period.

(ii) *Reminder notices.*—The investor's application and initial payment are forwarded by the dealer to the plan sponsor. The sponsor, after accepting the application, sends the planholder his certificate and, after deducting the sales load, deposits the remaining proceeds of the initial payment with the custodian bank, which establishes an account in the planholder's name. All subsequent payments are mailed by the planholder directly to the custodian bank rather than to the dealer or the plan sponsor. The custodian deducts and disburses from these payments the pertinent charges, which include its fee and the sales load and invests the balance of the proceeds in the underlying securities.

The custodian sends the planholder a receipt for each payment which, among other things, sets forth the amount of the payment, the various deductions from it and the number of whole and fractional shares of the underlying fund purchased with the remaining proceeds. Along with the receipt, the contractual planholder will also receive from the custodian bank a notice as to when the next payment is due and an addressed envelope for mailing it to the bank. If the next payment is not timely received, it is customary to mail the customer one or more reminder notices. The cost of sending reminder notices is indirectly paid for in part by the investor out of the custodian's fee.

(iii) *Investment of dividends and reinvestment of capital gains.*—Contractual plans provide for the automatic investment of dividends and

¹¹⁰ Sec. 27(a)(4).

¹¹¹ Special Study, pt. 4,263 (table XI-10).

¹¹² The Act requires a minimum initial payment of \$20. Sec. 27(a)(4).

¹¹³ They are obligated to administer the plan and to refrain from raising the sales load during the life of the certificate.

reinvestment of capital gains distributions paid on the underlying securities to the plan's custodian. Since sales loads on additional shares purchased with these proceeds have been prohibited, the additional shares are credited to planholders' accounts at net asset value."¹¹⁴

(iv) *Completion insurance*.—Completion insurance is a form of group term, declining balance insurance on the planholder's life. If the planholder dies, the proceeds of this insurance are used to complete the remaining payments on his plan certificate. Completion insurance is an optional feature of most contractual plans.

The monthly premium, which usually amounts to from 50 to 90 cents per thousand dollars of insurance coverage is deducted from each plan payment unit. If a planholder defaults in his insurance premiums by falling more than one month behind in his scheduled payments, the insurance automatically terminates.¹¹⁵ At the planholder's option the plan may be converted to one without insurance.

Plan sponsors and retailers usually receive no additional compensation from the monthly insurance premium. Since the insurance premium is an additional deduction from each payment, it reduces the proceeds available for investment. However, plans sold with such insurance have appreciably better payments records than those sold without insurance.¹¹⁶

(v) *Withdrawal and reinvestment*.—A planholder can usually redeem up to 90 percent of the net asset value of his investment, and later reinvest the amount withdrawn without paying an additional sales load. The withdrawal privilege does not lessen the burden of the front-end load. It is merely designed to give planholders an opportunity to use their certificates to meet emergencies without being subject to a second sales load when, and if, they repurchase the shares that they have previously redeemed.¹¹⁷

3. Front-end loading arrangements

As previously noted, the Act provides that the sales load on a periodic payment plan certificate may not "exceed 9 percent of the total payments to be made thereon" and that "no more than one-half of each of the first 12 monthly payments or their equivalent may be deducted for sales load."¹¹⁸ The Act also requires that sales charges be apportioned evenly on the first 12 payments or their equivalent, and that the remainder of the sales charge be spread equally over the balance of the plan payments.¹¹⁹ Thus, if a front-end load is deducted from the first 12 installments, a lower uniform sales charge must be deducted from each subsequent payment. These so-called "trail commissions" range from about 1.6 to 5.6 percent, depending primarily upon the number of payments provided for in the plan. The lower trail commissions gradually reduce the "effective" or cumulative average sales load paid so that if all contemplated payments are made, the investor ultimately pays approximately the same total sales load

¹¹⁴ In 1949 the Commission concluded that sales loads on planholders' reinvestments of capital gains and investments of dividends are prohibited by secs. 26(a)(2) and 27(a) of the Act because they could increase the sales loads on plan certificates to more than the 9 percent of the total payments to be made thereon.

¹¹⁵ The planholder usually may have the insurance reinstated within one year upon satisfactory proof of survival.

¹¹⁶ See *Investment Company Act*, p. 4, pp. 258-259, italics.

¹¹⁷ For discussion of the potential for abuse of this privilege, see pp. 304-306, infra.

¹¹⁸ See 27(a)(2).

¹¹⁹ See 27(a)(3).

he would have paid had he invested directly in the underlying plan shares.

Although most contractual plans provide for deducting the maximum 50 percent front-end sales load permitted by the Act, there are some variations from this practice. One large plan, sponsored by Waddell & Reed, Inc., has a front-end sales load of 46.4 percent; another plan, sponsored by Investors Diversified Services, Inc., and first offered to the public on October 1, 1965, provides for deductions of 20, 18, 18 and 7 percent, respectively, from the first, second, third and fourth years' scheduled payments (and 4.2 percent thereafter) instead of 50 percent in the first year.¹²⁰

A considerable number of contractual plans require that investors make an initial payment of two installments or more. Since a full front-end load is deducted from this payment and from the next 11 monthly payments or their equivalent, on these plans the front-end load applies to 13 instead of 12 monthly payment units.

Some contractual plans also offer a sliding scale of reduced sales loads on certificates which provide for relatively large monthly payments. These reductions usually apply to the trail commissions, but in most plans they do not apply to the front-end commissions when scheduled monthly payments are less than \$200.¹²¹ Moreover, unless the investor invests \$250 per month or more, the sliding scale of sales charges generally does not reduce the total contractual plan fees to a point where they amount to less than the costs of investing in a voluntary plan for the same underlying mutual fund shares. This is because the custodian's fee, usually deducted from each contractual plan payment, normally is not incurred in connection with voluntary plan payments.¹²²

The front-end load normally constitutes from one-half to as much as four-fifths of the total sales load on all scheduled payments. Thus, on a 10 year, 120 payment, \$25 per month plan (\$3,000) with a total sales load of 8.5 percent (\$255), the 50-percent deduction from the first 13 payment units equals \$162.50 (\$12.50 by 13 installments) or 63.7 percent of the total sales load to be paid on the plan.¹²³

When the typical 50 percent front-end load is calculated in the manner in which sales charges are calculated for exchange and over-the-counter transactions—as a percentage of the net amount actually invested in the security—it represents a sales charge on the first 13

¹²⁰ See 27(a)(3) of the Act requires that the sales load be deducted at a uniform rate from each of the first 12 monthly payments or their equivalent and at a uniform rate from each subsequent payment. Since this plan's front-end load is 20 percent rather than the permitted 50 percent, the plan was granted an exemptive order from the uniform post-front-end load requirement of the Act on the ground that such exemption was in the interest of investors. Investors Diversified Services, Inc., Investment Company Act Release No. 4261 (June 2, 1965).

¹²¹ Examination of the prospectuses of 60 contractual plan companies currently offering new certificates listed in one publication showed that 44 of the 60 provided for no reductions in the front-end load for monthly payments of less than \$200. Arthur Wiesenberger & Co., Investment Companies (1966 ed.) 133. For example, one plan, which provides for an 8.45 percent total sales load on a \$20 per month certificate and a 7.98 percent sales load on its \$50 per month Certificate, charges the full 50 percent front-end load on each certificate, but the trail commission on the \$50 per month certificate is 2.88 percent of each payment as compared to 3.40 percent on the \$20 per month certificate. For other plans, the front-end load itself may be reduced from 50 to, say, 45 percent where the amount of the monthly payment is \$50 or \$100. Further reductions in the front-end load on a sliding basis are generally provided for on certificates calling for monthly payments of \$200 or more.

¹²² See p. 77, *infra*.

¹²³ While the language of sec. 27(a) of the Act appears to indicate that no more than one-half of the first year's payments may be deducted for sales load, the language of the Senate and House committee reports states that the first year's sales load deduction could not be more than 50 percent of the total sales load on the entire plan certificate. The reports said that the provisions of that section "permit half of the sales load to be taken out during the first year but require the balance to be spread equally over the subsequent years." Senate Report 19. See also House Report No. 2639, 76th Cong., 3d sess. (1940) ("House Report") 22.

payment units of 100 percent. Indeed, the sales charge generally exceeds 100 percent of the actual net investment because, after deducting the custodian bank's fee, less than one-half of the planholder's first year's payments is actually put to work in the fund for his benefit.

4. Voluntary plans

As noted earlier, the voluntary plan is another method for investing in mutual fund shares on an installment basis. Unlike the contractual plan, the voluntary plan involves only one security and **only** one investment company. Under the voluntary plan each payment is directly invested in the fund's shares after deduction (in the case of load funds) **of** the normal load.

Although voluntary plans generally do not provide for formal investment goals or schedules, they can be used to make systematic monthly or other periodic payments toward achievement of investment goals. They frequently are used simply as a means **for** obtaining automatic reinvestment of capital gains and ordinary income dividends rather than as a systematic accumulation plan. Voluntary plans generally do not have formal monthly payment schedules, and reminder notices—aside from the form and envelope to be used **for** making the next payment which accompany each receipt—generally are not sent to the investor.¹²⁴

Unlike contractual planholders, investors in voluntary plans generally do not pay a custodian's fee. Instead, charges for the custodian's services are allocated among the principal underwriter, the dealer and the fund. Another distinction between the two types of accumulation plans is that voluntary plan investors are not afforded the 90 percent withdrawal and reinvestment option offered to contractual planholders.

About 20 voluntary plans are sold with optional completion insurance. Plans with completion insurance are formalized by the fixing, for insurance purposes, of a goal and schedule of payments. They operate in substantially the same manner as contractual plans with respect to reminder notices and charges for the services of bank custodians.¹²⁵

Many voluntary plans require initial payments of \$250 or more and subsequent payments of \$50 or more. These plans may be beyond the reach of many investors who can afford **only** the lower monthly payments called for by the contractual plan. A considerable number of voluntary plans, however, have payment minimums comparable to those on contractual plans.¹²⁶ Among 220 funds offering voluntary accumulation plans, 95—including 12 of 20 funds offering voluntary plans with completion insurance—have plans with no or moderate-sized minimum payments: 28 have no minimum initial or subsequent payment requirements; another 37 require initial payments of \$50 or less and subsequent payments of \$30 or less, respec-

¹²⁴ In both contractual and voluntary plans, receipts and where applicable, reminder notices are mailed by the bank which acts as custodian for the mutual fund securities. Although sec. 27(c)(2) of the Act requires that **only** contractual plans have a trustee or custodian bank for the underlying fund shares, in practice voluntary plans are also administered by custodian banks.

¹²⁵ The prospectuses of some of these funds indicate that a few States prohibit the offering of completion insurance with voluntary plans for the accumulation of mutual fund shares: California, Florida, Iowa, Missouri, North Carolina, Ohio, South Carolina, Texas and Virginia. Four of these States—Missouri, North Carolina, South Carolina and Texas—also prohibit the sale of completion insurance with contractual plans, and two others—California and Ohio—effectively prohibit the sale of contractual plans, with or without completion insurance.

¹²⁶ For example, one of the largest retailers in the contractual plan industry, Waddell & Read, Inc., requires a minimum initial payment of \$125 and minimum subsequent payments of \$25 on contractual plans for the accumulation of shares of United Accumulative Fund—its largest selling plan.

tively; and 30 require an initial payment of \$50 to \$100 and subsequent payments of \$50 or less.¹²⁷

5. The contractual plan purchaser

(a) General characteristics

A survey of mutual fund investors, made in 1962 for the Special Study by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania (Wharton Survey),¹²⁸ found that contractual plan purchasers generally were persons of moderate income with minimal accumulations of investable savings who were concerned with a safe, "savings" approach to investing. They were not speculators. They invested in funds to benefit from professional investment management, discipline in saving, economic growth, and portfolio diversification. The salesmen's representations that most influenced these investors were that contractual plans encourage regularity of saving, provide professional portfolio management, are "like savings accounts," provide portfolio diversification and are "safe."¹²⁹ Significantly, over three-fourths of these investors stated that they would not participate in the stock market in the absence of mutual funds.¹³⁰

The Wharton Survey found that the "typical" contractual plan investor was in his late 30's or early 40's, married with three dependents, had a high school education, an annual family income of between \$5,000 and \$10,000,¹³¹ and life insurance coverage of \$10,000 to \$15,000. About half of the contractual plan investors held clerical and sales positions, were skilled or semiskilled craftsmen, servicemen or housewives; the other half were self-employed, held executive or administrative positions, or were professionals.

The Wharton Survey further showed that 8 percent of contractual plan purchasers had no life insurance coverage and that an additional 16 percent had less than \$5,000 of life insurance coverage.¹³² Ten percent of contractual plan investors reported holding no savings accounts, savings bonds, other securities, or real estate other than their homes.¹³³ And, of course, many of those who did have nonfund assets other than their home may have held them in relatively small amounts.¹³⁴

One out of six contractual plan investors earned less than \$5,000 per year. Among this group, over four-fifths had bought plans which called for payments amounting to over 9 percent or more of their gross monthly income and, of course, a higher percentage of their take-home pay.¹³⁵

(b) Use and understanding of the prospectus

Contractual plan prospectuses, on their front cover pages and elsewhere, describe the method of deducting the front-end load and dis-

¹²⁷ Arthur Wiesenberger & co., *Mutual Fund Charts and Statistics* (1966 ed.).

¹²⁸ Special Study, pt. 4, pp. 265-373. See also *id.* at 139-146. For the methodology of the Wharton Survey, see *id.* at 269, 349-354.

¹²⁹ *Id.* at 358.

¹³⁰ *Ibid.*

¹³¹ *Id.* at 140, 274.

¹³² *Id.* at 274 (app. XI-A, table II-1).

¹³³ This latter group consisted typically of males of early middle age, with three or four dependents. Their incomes and life insurance coverage each were generally concentrated in the low end of the \$5,000 to \$10,000 range. Significantly, about two-thirds of the purchases of this group were reported as initiated by salesmen, compared with a little less than half for contractual plan buyers in the sample as a whole. (*Id.* at 301.)

¹³⁴ Except for life insurance coverage, the Wharton Survey did not inquire as to the value of the respondents' holdings.

¹³⁵ *Id.* at 280.

close the effective sales loads that are paid if the plan payments are not continued beyond the first and second years' installments, respectively. Approximately 90 percent of the contractual planholders responding to the Wharton Survey said that they had received the prospectus. The median time they reported reading it was 1½ hours.¹³⁶ Most contractual planholders also said that their salesmen had met with them for a median time of from 3 to 4 hours over the course of three meetings, and had described the first year's sales load as well as other features of the plans.¹³⁷

Despite the availability of the prospectus to and its use by planholders and despite explanations of the front-end load and other matters during sales presentations, responses to the Wharton Survey revealed that, 4 to 7 months after their initial payment, planholders had a rather low level of knowledge about their investments. For example, only one out of four contractual plan purchasers could make a reasonable estimate (considered for this purpose to be 5 to 15 percent) of the level of the sales load over the life of the contract.¹³⁸ Indeed, 40 percent of the responding purchasers could make no estimate as to the amount of the first year's sales charge and only 40 percent were able to make a reasonable estimate (considered for this purpose to be from 40 to 60 percent) of the first year's payments or their equivalent.¹³⁹ Thirty-one percent said there was no disadvantage if a contractual plan was not completed, and an additional 9 percent said that they did not know.¹⁴⁰

Similar responses were given by those who had redeemed contractual plans. Although the overwhelming majority of the redeemers had not completed their plan programs, about half did not know that the sales charge they had paid was a greater percentage of their investment than the percentage that they would have paid had they completed their plans.¹⁴¹

(c) *Redemptions by contractual planholders*

Many investors responding to the Wharton School's questionnaire who had redeemed uncompleted contractual plans did so because of financial stress.¹⁴² A substantial proportion of them used the cash received upon redemption — which averaged between \$300 and \$500 — as "rainy day" savings to pay hospital or medical bills (9 percent) and other types of debts (34 percent).¹⁴³

At the time of redemption about one-half of the contractual plan redeemers had no savings accounts and one-third had no financial assets or real property of any kind.¹⁴⁴ While no quantitative estimates can be made as to the size of the holdings of those who did have financial assets when they redeemed their plans, it is likely that in many cases such reserves were small.

6. *The sales environment*

The Special Study examined selling practices within the mutual fund industry and found evidence suggesting the existence of un-

¹³⁶ Id. at 311, 364.

¹³⁷ Id. at 295, 307.

¹³⁸ Id. at 313-316.

¹³⁹ Id. at 313.

¹⁴⁰ Id. at 366.

¹⁴¹ Id. at 372.

¹⁴² Over 90 percent of the redeemed contractual plans had not been completed; the time elapsed between initiation and redemption of the plan averaged less than 3 years, and was less than 6 years in 83 percent of the cases. Id. at 144, 331.

¹⁴³ Id. at 332. Expectations of a decline in securities prices influenced only about 20 percent of those who redeemed their contractual plans. Id. at 333.

¹⁴⁴ Id. at 328.

desirable practices "to an unfortunate degree."¹⁴⁵ Although its findings applied to sales of fund shares generally, it found that malpractices were particularly acute in contractual plan sales where the combined factors of the incentive for high-pressure selling provided by the front-end load, the essentially unsupervised nature of selling in customers' homes, the complexity of the securities sold and the lack of financial sophistication of many plan purchasers created "a problem of a fundamental nature."¹⁴⁶ The Special Study concluded that "the front-end load structure itself and the economic incentives which it gives to salesmen" were responsible for the inadequate protection of the public "from untoward pressures in contractual plan sales."¹⁴⁷

High turnover rates among salesmen are chronic in the securities industry generally, but the Special Study's data showed this problem to be particularly acute for the large contractual plan sales organizations. Heavy turnover rates cause these organizations to engage in the continuous and extensive recruiting of new salesmen from persons totally inexperienced in the securities business.¹⁴⁹

Recruits were encouraged to make their first contractual plan sales to themselves, then to friends and relatives, and thereafter, to obtain names of prospects through customer referrals, mailings and telephone calls and to use the "cold-turkey" call as a means of filling in gaps in appointment schedules. Most recruits, however, did not seem to progress much beyond sales to close friends and relatives. About two-thirds of contractual plan salesmen earned less than \$1,000 a year in the securities business.¹⁵⁰ Indeed, sales to friends and relatives of new salesmen appeared to account for a substantial portion of contractual plan sales. Thirty-five percent of the contractual plan purchasers in the Wharton Survey described themselves as a close friend or relative of their salesmen.¹⁵¹

Although sales trainees were trained to make the disclosures specifically required by the Commission's Statement of Policy¹⁵² and to obey the caveats in that statement, they also were taught to accompany these disclosures and caveats with sales techniques which deflect the prospect's attention from them.¹⁵³

The findings of the Special Study were not based on isolated instances of dubious conduct but mainly on sales training materials and sample sales presentations which were submitted to the Special Study by plan sponsors and other industry members and which were designed to be memorized or followed closely by trainees.¹⁵⁴ Since the publication of the Special Study in 1963 the plan sponsors have not

¹⁴⁵ Id. at 212.

¹⁴⁶ Id. at 211.

¹⁴⁷ Id. at 211.

¹⁴⁸ Over 40 percent of the sales forces of large mutual fund retailing firms, whose income was mainly derived from contractual plan sales, were hired and almost as great a percentage of their salesmen ceased working for them in 1961. Special Study, pt. 1, 33 (table I-11); pt. 1, 170-171 (tables II-9 and II-10); and pt. 3, 114-116.

¹⁴⁹ In 1961, nine out of ten salesmen newly employed by large mutual fund firms, most of which were contractual plan retailers, had no prior experience in the securities business. See Special Study, pt. 1, 170 (table II-8).

¹⁵⁰ Special Study, pt. 4, 266 (table XI-2). A salesman who sells a dozen \$25 per month contractual plans will earn about \$1,000.

¹⁵¹ Id. at 294.

¹⁵² Securities Act Release No. 3586, Investment Company Act Release No. 9621 (Oct. 31, 1957).

¹⁵³ For the Special Study's discussion of selling practices, most of which related to contractual plans, see Special Study pt. 4, 124-139.

¹⁵⁴ Special Stud., pt. 4, 341-342.

submitted more current sales training material, nor has the Commission requested that they do so. The current material may no longer contain items such as those cited by the Special Study.

7. *The impact of the front-end load on investors*

Improper selling practices are of particular concern in the case of contractual plans because the imposition of the front-end load creates special burdens for contractual planholders which other types of fund investors do not encounter. Whether characterized as a 50 percent front-end load or as a sales charge of 100 percent on the amount invested, when compared to the level-load method of deducting mutual fund sales charges the front-end load works to the disadvantage of all contractual planholders, including those who complete their plans on schedule.

(a) *All contractual planholders*

Because of the front-end load deduction, all contractual planholders, including those who complete their payments on schedule, have a smaller proportion of their payments invested in fund shares and working for them than if a level sales load had been deducted from each payment. This effect of the front-end load on contractual planholders who make and complete their payments on schedule is illustrated by chart V-1. It compares the average percentage of the investor's payments that are at work for him throughout a 10-year contractual plan with the corresponding percentage in a level-load voluntary plan of the same duration. An investor who seeks, through a voluntary plan, to accumulate shares of a mutual fund on which an 8.5 percent sales load is charged will always have 91.5 percent of his payments at work in fund shares. However, if that investor had sought to achieve the same goal through a 10-year contractual plan for shares of the same fund and had completed all his payments on schedule, only at the completion of the plan would he have as much as 91.5 percent of his payments at work in the fund for him. Because of the front-end load, only 50 percent of the first year's payments, and only an average of 87 percent of all his payments would have been working for him throughout the 10-year period.

Chart V-1 does not take into account reinvested income dividends and appreciation of capital. These, of course, are not constant and at any given time vary among different funds. Table V-4 demonstrates the effects of the front-end sales load for the 10-year period January 1, 1955, to December 31, 1964, a period of generally rising common stock prices. It compares the accumulated values of shares of Wellington Fund, Inc., acquired through payments of \$100 per month under contractual and voluntary plans.¹⁵⁵

¹⁵⁵ The table is based on the following assumptions: (1) monthly payments amounting to \$100 each for 10 years (total payments \$12,000); (2) the overall sales load under each type of plan, if carried to completion, amounts to 8 percent. On the contractual plan, however, 44 percent of each of the first 12 installments and 4 percent of each of the remaining 108 installments are deducted for sales load; (3) an annual custodial fee of 1.5 percent of each payment is deducted under the contractual plan; (4) income dividends are reinvested and capital gains distributions are accepted in additional shares at net asset value, with no adjustment made under either type of plan for any income taxes payable by shareholders on such dividends and distributions; and (5) the \$12,000 investment goal is achieved under each plan by systematic monthly payments.