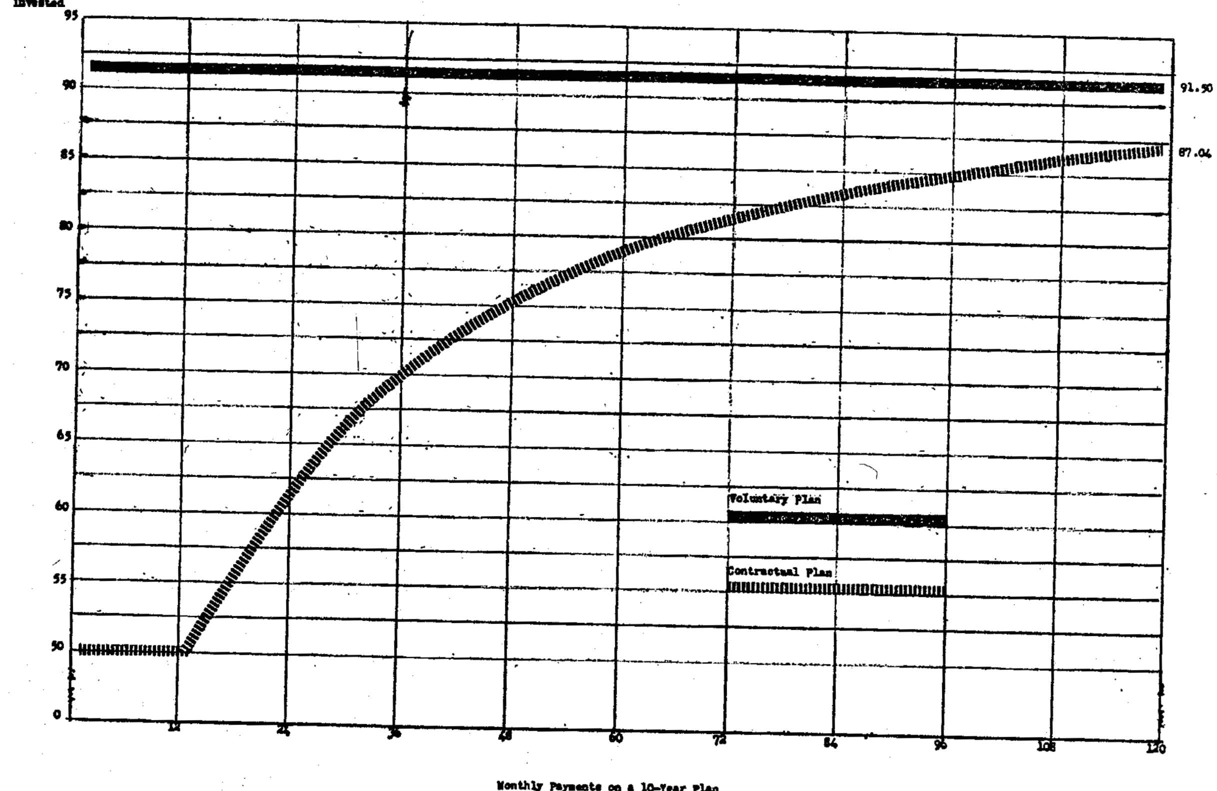
CHART V-1.—Average percent of payments at work for mutual fund investors,[1] voluntary plan versus contractual plan, 10-year plan.



[1] Assuming total load of 8.5 percent, double initial payment, no custodian's fees and deduction of a 50-percent front-end load from the first 13 contractual plan payment units.

TABLE V-4.—*Comparison of year-end values of voluntary and contractual plans in a balanced fund*

	Voluntary plan	Contractual plan	Amount of difference	Percent difference
Dec. 31—				
1955	$1,192	$635	$557	87.7
1956	2,366	1,822	544	29.9
1957	3,322	2,837	485	17.1
1958	5,548	4,969	579	11.7
1959	7,190	6,598	592	9.0
1960	8,736	8,153	953	7.2
1961	11,574	10,925	649	5.9
1962	12,105	11,533	572	5.0
1963	14,710	14,114	596	4.2
1964	17,460	16,844	616	3.7

The table shows marked differences in the accumulated values of shares acquired through front-end-load and level-load plans. At the end of the first year, the value of the shares held under the voluntary plan exceeded that under the contractual plan by 87.7 percent; at the end of the fifth year, the margin of difference in favor of the voluntary plan was 9 percent; and at the end of the tenth year, all scheduled payments having been made, there was still a margin of difference of 3.7 percent in favor of the voluntary plan.[156] Thus, the imposition of the front-end-load means, as one industry representative conceded: "In a long-term rising market the contractual plan usually won't turn out as well as a voluntary purchase plan." [157]

(b) Noncompleting planholders

Although the front-end load is likely to cause every contractual planholder to have a less favorable investment result than if only the normal 8.5 percent sales load had been deducted from each of his payments, contractual plans are especially costly investments for planholders who redeem or simply cease investing at an early stage in their payments schedule. These persons pay "effective" or cumulative average sales loads which often amount to many times the normal sales loads applicable to the underlying fund shares—effective sales loads which clearly would be "unconscionable or grossly excessive" [158] but for the express provisions of the Act with respect to front-end loads.[159]

More than a quarter of a century ago, when Congress enacted these provisions embodying the 50 percent front-end load formula, there was little specific data as to the effective sales loads that contractual planholders actually paid.[160] The data contained in the Commission's Investment. Trust Study only reflected aggregate losses—in part attributable to the market performance of underlying fund ,shares during the 1930's—from cancellations, defaults, and withdrawals in plans in existence for periods of 3 to 5 years.[161] It did not show the

[156] For the period 1953 through 1962, larger differences would have resulted from investing in shares of thir fund through a voluntary and contractual plan. At the end of that 10-year period the margin of difference—in favor of the voluntary plan—was 5.1 percent. See Special Study, pt. 4. 182 (table XI-d).
If a growth fund rather than a balanced fund were used for the comparison, even greater differences in investment results would likely result during periods of rising market prices.
[157] Forbes Magazine, Sept. 1, 1962, p. 46.
[158] Act, secs. 22 (b) and (c).
[159] Act, sec. 27(a).
[160] See Investment Trust Study, *Supplemental Report on Companies Sponsoring Installment, Investment Plans*, H.R. Doc. 482, 76th Cong., 3d sess. (1940), 64–69.
[161] That study also noted that in data submitted in response to the Commission's questionnaire, "a consistent distinction between cancellation, default, and withdrawal was not bbserved." Id., 69.

distribution of accounts paying various effective sales loads. The Investment Trust Study noted that—

> since most of the certificates, which usually have IO-year payment periods, were purchased within recent years, only very few of the installments have as yet been paid.[162]

(i) *The Special Study statistics.*—To determine the effective sales loads paid by contractual planholders, the Special Study obtained payments records for a systematic 10 percent sample of accounts opened in February 1959 by the nine largest contractual plan companies. These companies accounted for 82 percent of the total payments provided for in all contractual plans outstanding at the end of 1959. The Study analyzed the monthly payment records of these plans during the ensuing 3½-year period ending August 31, 1962.

The Special Study found that only 3½ years after the plans were purchased, 35.6 percent of the accounts had become inactive, either through redemptions prior to completion or through lapses in payments for a period of 12 or more consecutive months. Nearly one out of every six of all accounts (16.2 percent) became inactive at a point where the planholder had paid an effective sales load of 50 percent (or a sales charge of over 100 percent on the amounts invested). Also inactive were an additional 10.1 percent of all accounts which had paid effective sales loads of between 25 and 47 percent (sales charges of 33 to 89 percent); an additional 4.7 percent which had paid effective sales loads of 20 to 25 percent (sales charges of 25 to 31 percent); and another 4.6 percent which paid effective loads of 8.5 to 20 percent (sales charges of 9.3 to 25 percent). Thus, these inactive accounts had paid effective sales loads substantially in excess of the 8.5 percent load contemplated for completed plans.[163]

The Special Study's breakdown of the effective sales loads paid by inactive accounts demonstrated that lapsed plans accounted for a substantially larger proportion of the inactive accounts than did redeemed accounts.[164] Redeemed certificates accounted for 13.5 percent of the February 1959 contractual plan purchasers,[165] but lapsed accounts represented another 22.1 percent of the sampled planholders. The Study noted that over the 3½ year period, 4 out of every 20 lapsed accounts were reactivated, but that 1 of these 4 lapsed again. While the increase in lapsed accounts was greatest in the second year, the pace of redemption—in part of accounts already lapsed—continued rising in the third year.[166]

(ii) *The AMFPS statistics.*—Subsequent to the publication of the Special Study, the Association of Mutual Fund Plan Sponsors, Inc. ("AMFPS"), an industry trade association whose membership consists of some 19 contractual plan sponsors, presented to the Commission a detailed reply to nearly all of the findings, conclusions, and recommendations of the Special Study with respect to sales of contractual plans.[167] The AMFPS Presentation contains statistics which supplement those of the Special Study relating to the effective sales loads paid by contractual plan investors.

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162 Investment Trust Study, pt. 2, 40.
163 Special Study pt. 4, 191 (table XI-e).
164 Special Stud; pt. 4, 191, 262 (tables XI-e and XI-9).
165 An additional 1.3 percent were redeemed with full reimbursement of the sales load either in accordance with a refund privilege or for other reasons. Id. at 188.
166 Ibid.
167 Presentation by the Association of Mutual Fund Plan Sponsors, Inc., to the Securities and Exchange Commission Relating to Chapter XI of the Special Study of Securities Markets ("Presentation").

The Special Study's statistics were limited to a 3½ year period.[168] This raised the possibility that effective sales loads would be reduced because of reactivation of lapsed accounts as well as the probability that some accounts which had been active during the 3½ year period would thereafter lapse or be redeemed prior to their completion. However, analysis of AMFPS statistics, which show the number of contractual plan payments made by the end of 10- and 12-year periods, indicates effective sales loads which approximate the findings of the Special Study for the more limited period.

The data submitted by AMFPS show the payments status of all contractual plan accounts opened 10 or 12 years previously by four plan sponsors.[169] Table V–5, directly below, reflects for each of

TABLE V–5.—*Status of 4 AMFPS members' contractual plan accounts 10 or 12 years after being opened*

Number of installments paid	Percent of accounts	Effective sales load [a]	Effective sales charge [b]	Number of installments paid	Percent of accounts	Effective sales load [a]	Effective sales charge [b]
2 to 13 [e]	18.92	50.0–50.0	100.0–100.0	1 to 12	13.77	50.0–50.0	100.0–100.0
14 to 25	8.77	46.7–27.9	87.6–38.7	13 to 24	6.18	46.7–27.9	87.6–38.7
26 to 37	7.16	27.0–20.7	37.0–25.3	25 to 36	4.86	27.0–20.2	37.0–25.3
38 to 49	7.30	19.3–15.8	23.9–18.7	37 to 48	5.04	19.7–16.2	22.1–19.3
50 to 61	6.03	15.6–13.3	18.3–15.3	49 to 60	4.30	16.0–13.8	19.0–16.0
62 to 73	5.22	13.2–11.7	15.2–13.3	61 to 72	4.62	13.6–12.2	15.7–15.7
74 to 85	3.75	11.6–10.5	13.1–11.7	73 to 84	3.73	12.1–11.0	13.8–12.3
86 to 97	3.18	10.4–9.6	11.6–10.6	85 to 96	4.11	10.9–10.2	12.2–11.4
98 to 109	3.48	9.6–9.0	10.6–9.9	97 to 108	3.38	10.1–9.5	11.2–10.5
110 to 119	7.90	8.9–8.4	9.8–9.2	109 to 119	6.43	9.4–8.9	10.4–9.8
Paid up	28.29	8.4	9.2	Paid up	43.58	8.9	9.8
Status as of Oct. 31, 1963 of accounts opened in 1951 by Hamilton Management Corp.[f]				Status as of Aug. 30, 1963, of accounts opened in 1953 by Waddell & Reed, Inc.[g]			
2 to 13 [e]	20.43	50.0–50.0	00.0–100.0	5 to 16 [h]	17.13	46.4–38.0	86.6–61.3
14 to 25	12.77	47.6–28.2	90.8–39.3	17 to 28	8.79	35.9–22.4	56.0–28.9
26 to 37	9.48	27.3–20.6	37.6–25.9	29 to 40	7.43	21.7–16.2	27.7–19.3
38 to 49	6.25	20.1–16.6	25.2–19.9	41 to 52	6.08	15.8–12.8	18.8–14.7
50 to 61	6.38	16.4–14.3	19.6–16.7	53 to 64	4.43	12.6–10.7	14.9–10.0
62 to 73	3.56	14.1–12.7	16.4–14.5	65 to 76	3.45	10.6–9.3	
74 to 85	4.50	12.6–11.5	14.4–13.0	77 to 88	3.43	9.2–8.2	9.9–8.9
86 to 97	2.69	11.[illegible]–10.7	13.0–12.0	89 to 99	2.49	8.1–7.5	8.8–8.1
98 to 109	3.96	10.6–10.0	11.9–11.1	Paid up	46.77	7.4	8.0
110 to 121	2.89	9.9–9.5	11.0–10.5				
122 to 133	2.35	9.4–9.0	10.4–9.9				
134 to 145	3.56	9.0–8.7	9.9–9.5				
Paid up [i]	22.18	8.6–8.5	9.4–9.3				

[a] For minimum denomination plans.
[b] Sales load expressed as a percentage of the [illegible] invested [illegible] into account [illegible]ctions for [illegible]todians' fees.
[c] Experience of 2,987 [illegible] accounts f[illegible] th[illegible] of shares [illegible] Industrial Fund, Inc.
[d] Experience of 8,532 120-payment accounts for th[illegible] accumulation of shares of Wellington Fund, Inc.
[e] Initial payment of 2 installments.
[f] Experience of 1,488 150-payment accounts for the accumulation of shares of Hamilton Funds, Inc.
[g] Experience of 4,174 100-payment accounts for the accumulation of shares of United Accumulative Fund.
[h] Initial payment of 5 installments.
[i] Includes accounts which have made 146 to 149 installments as well as those that are [illegible]

Source: Prese[illegible]ti[illegible], pt. V, [illegible]le V-1 through V-4

[168] The Study explained the basis for its 3½ year sampling of contractual plan account payments, thusly: "February 1959 was sele[illegible]ted as [illegible] t[illegible]pical month, recent enough to reflect current selling practices, yet sufficiently distant in tim[illegible] t[illegible] [illegible]h[illegible] w[illegible] [illegible]ral years of payment, lapse, and redemption performance." Pt. 4, 187. The reference to current practices reflected the Special Study's awareness of at least one new element which might have affected selling practices—the organization of the AMFPS and its promulgation in 1958 of a code of ethical business condu[illegible]t whi[illegible] [illegible]ong other things, obligates members to offer a 30-day refund privilege to each new investor [illegible] Alt[illegible]g[illegible] the last three months of the period studied followed the May 28, 1962 market break, there was no acceleration of redemptions or lapses in June July or August of 1962. Id. at 188–190, 257 (table XI-4)

[169] Presentation, pt. V, tables V-1 through V-4.

the four contractual plans the percentages of paid-up accounts and the percentages of accounts that had **not** been paid up. It also reflects the sales loads paid on these accounts, expressed as percentages of the payments made ("effective sales charge").[170]

The AMFPS data reveal that after 10- and 12-year periods, 35, 25, 43, and 33 percent, respectively, of the purchasers of contractual plan certificates sponsored by Financial Programs, Inc., First Investors Corp., Hamilton Management Corp., and Waddell & Reed, Inc., had paid no more than the installments scheduled for the first 3 years and that about half of these purchasers had not progressed beyond the first year's installments. Hence these planholders had paid effective sales loads of 20 to 50 percent (sales charges of 25 to 100 percent of the amount invested) in the first three sponsors' plans and of 16 to 46.4 percent (sales charges of 19 to 87 percent) in the fourth sponsor's plan. By comparison, the Special Study's sampling showed that 3½ years after being opened, 31.9 percent of contractual plan accounts were inactive after payment of 1 to 36 installments. Another 8.5 percent of the plans in that sampling, though not classified as inactive, fell within the 1 to 36 installments category.

Significantly, AMFPS' duration-of-the-plan statistics supply information not previously known on the percentage of plans which are timely completed. They reveal that 10 and 12 years after purchasing contractual plans, a substantial majority of planholders had not completed them. By 1963, 2 years after the completion date of the Waddell & Reed, Inc. 8-year plans sold in 1953, only 47 percent of those planholders had completed their payments; at or about the end of the 10-year payment periods for the plans sponsored by First Investors Corp. and Financial Programs, Inc., only 44 percent and 28 percent of the respective purchasers had completed their payments; and at the end of September 1963 completions accounted for only 22 percent of the 12½-year contractual plans sold throughout 1951 by Hamilton Management Corp. The AMFPS statistics also reveal that about 39, 34, 48, and 59 percent of the four plan companies' respective purchasers had made less than half of their payments and that 32, 41, 26, and 55 percent of their respective purchasers had redeemed uncompleted contractual plan certificates during the 10- and 12-year periods considered.

8. The industry's justifications for the front-end load

The front-end load increases the cost and adds materially to the risks of investing in mutual funds. The implications of this type of sales charge are extensively disclosed in contractual plan prospectuse and in sales presentations. Nevertheless, contractual plans are sold in substantial numbers to investors whose ability to assume the added burden attributable to the front-end load is highly questionable. Most contractual plan purchasers pay effective sales loads which would be considered excessive under any standard for measuring the

[170] See p. 205, supra.

reasonableness of sales compensation in the securities industry but for the express sanction that the Act gave to the front-end load more than 25 years ago. The Special Study concluded that "[i]t is the front-end load structure itself and the economic incentives which it gives to salesmen which are responsible for the failure of the disclosure concept adequately to protect the public * * *," and it recommended that "serious consideration should be given to the elimination of future front-end load plans." [171]

The AMFPS' extensive reply to the Special Study's findings and conclusions advances four principal justifications for preserving the statutory provisions which permit front-end loads. They are: (1) the stimulus to systematic investing provided by the front-end load; (2) the extensive disclosure requirements applicable to contractual plans; (3) the profitability of contractual plan investments; and (4) the necessity of preserving adequate incentives to sell mutual fund investments to investors of modest means.

(a) The front-end load as a stimulus to systematic investing

The Special Study observed that "the sellers of contractual plans do stress discipline in saving as a major advantage of contractual plans and that a substantial number of investors are moved to purchase them on this account." [172] However, the role which the front-end load plays in stimulating regular investing is questioned by the Special Study's findings that within 3½ years after beginning the plans substantial portions of contractual planholders had made no payment for at least a year or had redeemed their plan certificates. It is further questioned by the evidence in the AMFPS Presentation that 10 and 12 years after beginning the plans substantially less than one-half of the nlanholders had completed them and that from one-third to three-fifths of the planholders had made less than half of the scheduled payments. The Special Study also found a substantial proportion of all accounts in its sampling of contractual plans opened in February 1959 had not systematically invested.[173]

The ineffectiveness of the front-end load as a stimulus to systematic investing is further evidenced by the responses of contractual plan purchasers and redeemers in the Wharton School survey. The front-end load cannot be said to have served as such a stimulus for the 4 out of 10 purchasers who, several months after their initial payment, were unaware of the disadvantage imposed by the front-end load on those who fail to complete their payments. Nor could it so serve for the one-half of the contractual plan redeemers who were unaware of this disadvantage.

For those contractual planholders who do invest systematically, factors unrelated to the front-end load itself—a fixed goal and schedule of payments, regular reminders and the purchase of completion

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[171] Special Study, pt. 4,211.
[172] Id. at 182.304.
[173] The Study noted:

"The general participation of planholders fell off considerably during the 43-month period. In the first month after the plans were initiated, payments of single or multiple installments were received from 71 percent of the planholders. The number of remitting accounts rose slightly in May and June of 1959, but thereafter diminished rather steadily to 65.1 percent in February 1960, 53.7 percent in February 1961, and 43.2 percent in February 1962. In August 1962, payments were received from only 39.8 percent of the accounts initiated 3½ years *before*.

"The number of months in which planholders make payments—and correspondingly, the number of planholders making payments in any month—as described above may be affected by the extent to which multiple-installment payments are made. Of the entire group 'studied, fully 87 percent paid multiple installments in their initial payment in February 1959. On the other hand some 83 percent of all payments made by all planholders after the first payment were of single installments." Id. at 190.

insurance—"* * * may be as important stimulants as the penalty involved in the load." [174]

Indeed, there is some evidence that persons investing in voluntary plans with completion insurance, which do provide the goal, schedule, and reminder notices featured in contractual plans, have at least as high a persistency record of payments as purchasers of contractual plan certificates of similar denominations. Statistics were submitted to the Commission by the Putnam Fund Distributors, Inc., for the period from 1954, when such voluntary plans were first offered by that organization, until the end of May 1963, with the bulk of new voluntary plan accounts having been opened during the latter years of that period. The statistics showed regular monthly or quarterly payments (as provided for on their application) of no less than $50 were made without fail on 85.4 percent of all the plans.[175]

(b) Disclosures applicable to sales of contractual plans

The plan sponsors assert that "almost the entire sales presentation is in the form of a prospectus and sales literature which must and do conform to the laws and regulations * * *" [176] and that "almost all of the information upon which the contractual plan customer must base his investment decision is included in the prospectus and other sales materials supplied to him by the salesmen." [177] They suggest that the question of the front-end load should be left to the investors, stating:

> It is the universal experience of the American free economy that people do not continue to buy for very long or in very great quantity anything that they do not think is worth what it costs.[178]

However, Congress determined at the time of the passage of the Act that disclosure alone provided inadequate protection to purchasers of investment company shares. The House Report on the bill which became the Investment Company Act stated with respect to the investor protections afforded by the Securities Act of 1933 and the Securities Exchange Act of 1934:

> Generally these Arts provide only for publicity. The record is clear that publicity alone is insufficient to eliminate malpractices in investment companies.[179]

Experience under the Act has shown that disclosure does not protect the many contractual planholders who pay exceedingly high effective sales loads on redeemed and inactive plans.

The contractual plan sponsors question the feasibility of making data regarding lanses and redemptions intelligible to the average reader of a prospectus.[180] They assert that:

> [t]he wholly personal reasons underlying past investors' decisions to redeem or miss payments have absolutelv no bearing upon the financial position of any other individual investor.

[174] Id. at 203.
[175] Id. at 198–199. As the Special Study noted "These statistics do not reflect the number of voluntary plans with completion insurance purchased each year nor the payment records for plans initiated in each year from 1954–63. * * * Despite their inconclusive nature, the statistics seem to indicate a very high proportion of systematic payments, even when compared to *the* insured contractual plan accounts of denominations of $50 per month and over in the study's IC–8 sampling * * *." Id. at 198.
[176] Presentation pt. I, 21–22.
[177] Presentation: pt. IV, 67.
[178] Id. at 7.
[179] House Report 10.
[180] Presentation, pt. IV, 87.

> Thus, if the purchaser is convinced that he will be able to carry his plan through to completion, the individual failures of a minority of other investors should not concern or deter him.[181]

They maintain that the simple question, "Do you think that *you* can complete this plan?" would render such data entirely superfluous.[182] However, based on the data submitted by them, the "minoritv of other investors" who, the plan sponsors assert, fail to complete their plans may well be a majority. Moreover, the plan sponsors' justification for the use of a front-end load in the sale of long term investment programs does not consider the fact that whether any individual investor will have the financial resources and the willingness to commit, those resources to equity securities for a period of **10** years or more is a highly uncertain determination at best. Lapse and redemption data for past years show that large numbers of contractual planholders have not completed their plans and have paid high effective sales loads on the amount invested.

(c) The profitability of contractual plan investments

The plan sponsors have presented extensive statistical information to demonstrate—

> that by far the large majority of investors in contractual plans have profited very substantially from their investments and the losses suffered by the relatively few have been exceedingly small in comparison.[183]

They also claim that "the highly favorable results shown were achieved *after the deduction of the front-end load* at whatever rate." [184]

Although **AMFPS** referred to the accounts that suffered losses as **a** "relatively few," tbey consisted of **9, 33,** *3,* and **24** percent, respectively, of the contractual plan accounts for accumulation of shares of Financial Industrial Fund, Inc., Hamilton Funds, Inc., United Accumulative Fund, and Wellington Fund, Inc. All these accounts were redeemed at a loss.[185] In addition, many of the individual nonredeemed accounts in the low payments categories undoubtedly reflected potential losses 10 or **12** years after being opened.[186]

Since the fund shares underlying all these contractual plans generally appreciated in value during the periods in question, such losses and potential losses were primarily the result of the front-end load. Moreover, the relatively small dollar amounts of losses in comparison to profits merely reflects the fact that the great majority **of** accounts which suffered losses had paid fewer installments and, accordingly, had less invested than most of the accounts which showed a profit.

More important, in the Commission's view, reliance on the profits realized or realizable by contractual plan investors ignores the funda-

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181 Id. at 86–87.
182 Id. at 86-87. Emphasis is AMFPS'.
183 Presentation, pt. I, 30.
184 Id. at 28. Emphasis is AMFPS'.
185 Presentation pt. V, tables V-1 through V-4.
186 For example, 11.6 percent of contractual plan accounts for the accumulation of shares of Financial Industrial Fund, Inc., by yearend 1962 were not terminated and in *the* 2–13 payment units *category*. In the aggregate $48,586 was paid on those accounts and they had a market value at yearend 1962 of $40,907. Another 5.5 percent of the nonterminated accounts were in the 14–25 payments category. In the aggregate they paid $104,491 and had a *market* value at yearend 1962 of $103 546. It is likey that most of those accounts In the 2–13 payments category and a large proportion of those' accounts in the 14–25 payments *category* would have sustained losses had they been redeemed at yearend 1962, 10 years after they were opened.

mental standard of fairness which should govern the charges for securities transactions. The Special Study summed it up as follows:

> In any event, the rationale of justifying a front-end load on the long-range success of many contractual plan purchasers appears to miss a significant point. In the securities business generally, including the mutual fund field specifically, the reasonableness of a commission rate or markup is judged in relation to the amount invested, not the ultimate success or failure of the investment. The contractual plan industry is unique in justifying its sales load by the ultimate average success of the investors involved.
>
> The industry argument based on the ultimate profitability of most plans generally ignores the larger profits which would be available to a contractual planholder making equal payments on a voluntary plan.[187]

To the extent that contractual planholders have realized profits on their investments because of mutual fund performance in the generally rising securities markets of recent years, those profits were achieved despite the front-end load. The front-end load itself makes no contribution to fund performance records (a separate fee is paid for fund management). Nor is a contractual plan investment a profit-sharing arrangement under which the load is reduced or eliminated in case of market losses. The front-end load cannot be justified by reference to the profitability of some planholders' investments.

(d) The front-end load as a necessary incentive for salesmen

A further justification for the front-end load put forth by the contractual plan industry is that it is the only means of compensating salesmen adequately for bringing to the small investor the opportunity for equity investments through the medium of mutual funds. Even assuming that this claim is valid and that this end is desirable, does it justify the means—the front-end load—since much of the investor's first-year payments is not used for his benefit and since he actually prepays sales loads for future investments which there is a good likelihood he will never make?

Moreover, though the Contractual plan is a long-range program for systematic investing, the front-end load only provides retailers with a strong incentive to get purchasers to initiate such a plan, regardless of their circumstances, in order to realize commissions on at least the front-end portion of the load.[188] After these first-year payments are made, the salesman's interest in the completion of the plans he sells is sharply eroded by the fact that his commissions are substantially decreased. They amount to about $1 on each $50 payment. This is only about one-twelfth of what he receives on the first year's payments and one-half of what he would receive from a payment of a like amount on a voluntary, level-load plan.

The problem is compounded by the practice of encouraging prepayment of installments subject to the front-end load. This provides no advantage to the plan purchasers who could use the amount of their prepayments to purchase shares at level loads. But it does limit the time period during which the salesman has a direct financial incentive to encourage his customer to invest systematically.

[187] Special Study, pt. 4, 181.
[188] Ibid.

Once the first year's payments have been made, it may be to the salesman's advantage to continue to service his customer by encouraging him to persist in his program. The salesman may thereby obtain customer goodwill which may lead to repeat sales and references to other prospective customers. However, the high proportion of customers who, 10 or 12 years after purchasing contractual plan certificates, have made substantially less than half their payments [189] suggests either that post-front-end load followup is not practiced or, if it is, that customers are nevertheless unable or unwilling to continue to make payments. If unwilling, it is remarkable that customers are more easily persuaded to make payments subject to a **50** percent load then to make payments from which only a 3 or 4 percent sales load is deducted. Moreover, the high turnover of salesmen in the contractual plan industry raises the question of whether, after the front-end load reward has already gone to other salesmen, new salesmen will expend time and effort to persuade customers to maintain plan payments which earn them next to nothing in commissions. These salesmen can more profitably spend their time obtaining front-end load commissions on new contractual plan sales.

The front-end load encourages a nonselective approach to soliciting customers. The contractual plan salesman's list of prospective customers admittedly is far less selective than that of the regular account mutual fund salesman and the percentage of customers refusing to invest will be higher for the contractual plan salesmen.[190] Although such lack of selectivity may result in more persons being made aware of mutual funds as a vehicle for investment, its logic would lead to the conclusion that an even larger front-end load should be permitted so that even more persons could be approached through even less selective screening of potential customers.

The front-end load in contractual plans also has been defended on the ground that salesmen in other fields are similarly compensated. The AMPPS presentation states:

> It should be noted that there is nothing unusual about front-end loads. Not only every purchaser of life insurance, but every purchaser of a home with a long-term mortgage, and every purchaser of an automobile or a household appliance, or anything else bought "on time," pays the equivalent of a front-end load; although in each case the penalty for interruption of payments is likely to be far more drastic than in the case of a contractual plan.[191]

In the Commission's view, there is no basis for analogizing the purchase of merchandise or insurance on the installment basis to front-end load plans for investing in mutual fund shares. Buyers of houses, automobiles, or household appliances immediately obtain the full enjoyment of their purchases. The contractual planholder, on the other hand, **does** not obtain the investment benefits of a fully paid plan until he completes his payments. When his first year's scheduled payments have been completed, 50 to 80 percent of the sales load on the entire plan has been deducted; [192] yet only about **5** to **6** percent of the total net investment contemplated under his plan has been made.

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189 See pp. 239-240, supra.
190 Presentation, pt. IV, 19. *See* also Special Study, pt. 4,125-129.
191 Presentation, pt. I, 11.
192 The amount of the variation primarily depends on the length of the plan.

Even though the purchase of life insurance may involve a front-end load, it must be noted that life insurance purchasers—primarily interested in providing, in the event of their death, support for their dependents[193]—immediately receive the full measure of the contemplated death protection, not 5 percent of it. Moreover, there are significant distinctions between the front-end loads paid to contractual plan salesmen and the payment to life insurance agents of a large proportion of the first year's insurance premium. While the compensation of insurance salesmen may depend upon the type of life insurance policy sold, the differences are very moderate in comparison to those which prevail in the sale of mutual fund accumulation plans. Thus, once it has been determined that a customer will spend a given amount per year, say, $300 on life insurance, the agent can give advice as to what type of insurance obtainable for that money would best suit his customer's needs (e.g., a straight life policy, a limited payment life policy, a 10- or 15-year endowment, or diminishing-balance term insurance) without his income being very substantially affected by the customer's choice.[194]

The front-end load in the contractual plan industry does not operate in the same manner. Although both contractual and voluntary accumulation plans can be used to achieve the same type of investment objectives, the salesman's first year commission is five times greater if he sells a front-end load contractual plan rather than a level-load voluntary in the same mutual fund shares.[195] As a result, the front-end load effectively precludes many dealers and their salesmen from giving adequate sales presentations of level-load accumulation plans to persons of modest means.

9. *The Commission's conclusions and recommendations respecting contractual plans*

The front-end load places contractual planholders in a unique position. Besides normal investment risks, they assume a sales charge burden which can never be entirely neutralized and can be appreciably mitigated only by completing their investment program. As has been seen from the Special Study and AMFPS statistics, many investors—frequently because of financial circumstances beyond their control—do not persist in their payments long enough to achieve that goal.

In 1940 Congress and the Commission saw fit, on the basis of the data then at hand, to permit a front-end load of no more than 50

[193] Life insurance, except for term insurance policies, does contain a savings element (represented by investment in debt securities), the operation of which is postponed by the front-end load. This element, however, is secondary among the reasons why people buy life insurance. See Institute of Life Insurance, The Life Insurance Public as Portrayed by a Nationwide Survey of Life Insurance Ownership and Attitudes (1957) pp. 44–47. Spontaneous responses to the question, "Which would you say are the major reasons for carrying life insurance?" were: support for dependents (67 percent); cleanup funds (38 percent); saving (18 percent); education (7 percent); retirement income (6 percent); borrowing (6 percent); and mortgage repayment (1 percent). When shown a card listing each of these reasons the uses of life insurance which relate to its investment aspects were listed by larger proportion of respondents. Combining responses to spontaneous and suggested reasons the results were: support for dependents [illegible] percent; cleanup funds (83 percent); retirement income (4[illegible] percent); saving (40 percent); [illegible] ([illegible]0 percent); mortgage repayment (32 percent); and borrowing ([illegible] percent).

[194] The typical commissions paid to agents from first year life insurance premiums are 55 percent for ordinary life policies and 35 percent for term insurance policies among companies operating in New York State and 65 percent and 40 percent, respectively, among companies which do not sell insurance in that State.

[195] By comparison, the life insurance salesman's first year median commission is but three-fifths larger if he sells an ordinary life policy rather than a term policy, assuming the same premium payment. The far greater discrepancy between contractual plan and voluntary plan commissions exists despite the fact that, unlike ordinary life and term policies which provide different types of protection, both types of mutual fund accumulation plans are essentially an investment in the same security and can serve identical investment objectives.

percent. In the ensuing years, front-end load plans have been given a full and fair opportunity to prove that they can be sold without adversely affecting investors. The experience of those years—reflected in the prevalence in the Special Study and AMFPS statistics of high effective sales charges paid on large proportions of accounts that were redeemed, lapsed, and uncompleted—has demonstrated the need for a more thoroughgoing solution than the interim one made in **1940.** Against the pressures generated by the sales incentive of the front-end load, the disclosures of the costs and risks involved in contractual plan investment have been and are likely to continue to be ineffective protection for the investing public.

It is anomalous that of all investors in equity securities only the contractual plan purchaser—who is so concerned with minimizing speculative investment risk—is burdened with a front-end load sales charge that increases the possibility of loss and decreases the possibility of gain.

The Commission therefore recommends that the Act be amended to prohibit the deduction of front-end loads in future sales of investment company securities.

The Commission also recommends that the maximum aggregate permissible sales load for contractual plan certificates be reduced from the present level of 9 percent to the 5 percent level that it considers appropriate for other types of mutual fund investments. There is no reason why contractual plan purchases should be especially costly to investors.

The foregoing should not cause any contractual planholder to redeem or cease making payments on his certificate. Early redemption of a plan almost always results in loss to the planholder. Planholders who cease making payments fail to utilize the opportunity to invest in fund shares at reduced sales charge rates which apply to payments scheduled to be made after the first year of the plan. The recommendations are focused solely on *future* sales of contractual plans.

10. The front-end load on face-amount certificates

(a) Introduction

Like contractual plans, face-amount certificates provide for the periodic investing of specified amounts in monthly, quarterly, semiannual, or annual payments. However, face-amount certificates are debt rather than equity securities. They have terminal values which are fixed at the time of purchase. At a specified maturity date (such as 6, 10, 15, or 20 years after their purchase) the face-amount certificate company must pay the investor the sum of money specified in the certificate. Reduced rates of return are provided if the investor redeems his certificate prior to its maturity.

The Act requires face-amount certificate companies to maintain specified minimum reserves.[196] Unlike the provisions of section 27(a) with respect to contractual plans, the Act's face-amount certificate provisions make no express reference to sales loads. The effect of the minimum reserve requirements, however, is to permit deduction of a maximum sales load of 7 percent on the aggregate *gross* annual

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[196] Sec. 28(a)(2)(A) and (B).

payments to be made and the deduction of as much as a 50 percent front-end load from the investor's payments by the end of the first year's scheduled installments.[197] It further allows the deduction of as much as a 7 percent sales load from payments scheduled for the second through fifth years of the plan, and as much as a 4 percent load from payments scheduled for any subsequent year.[198] Thus, as in contractual plans, most of the sales charges for face-amount certificates can be deducted from the payments made during the first few years. If the investor redeems at an early point in his payment schedule, he will receive substantially less than his total payments.

At present there are six face-amount certificate companies in operation. Their total net assets on June 30, 1966, were $1.1 billion or about 2.3 percent of all registered investment companies' net assets as of that date. Face-amount certificates issued by Investors Syndicate of America, Inc., a wholly owned subsidiary of Investors Diversified Services, Inc. ("IDS"), and those issued by IDS itself prior to the passage of the Act account for over 95 percent of the assets of all registered face-amount certificate companies.[199] Investors Syndicate currently offers 15- and 20-year certificates which upon maturity pay interest, compounded annually, at rates of 2.52 and 3.01 percents, respectively—less if not held to maturity. They provide for a minimum surrender value of 80 percent at any time after sale.

(*b*) *Investor payment experience*

An analysis prepared by IDS of the payment experience of its face-amount certificate investors, reproduced in table V-6, shows the status at the end of 1961 of 2,000 15-year certificates sold during the months of July 1941 and January 1945. The table shows the payments made on 1,852 of the 2,000 certificates as of a time subsequent to their scheduled completion.[200]

Of the 1,852 accounts, 310 (16.7 percent.) were terminated before 6 monthly payments or their equivalent had been made.[201] Another 349 (18.8 percent), on which 7 to 35 monthly payments or their equivalent had been made, had been surrendered.[202] Only 594 (32.1 percent) had been completed. These figures are similar to the Special Study and AMFPS statistics on the payment experience of contractual plan investors. Moreover, substantial numbers of face-amount certificate investors who did not complete their plans lost money because of the front-end sales load deduction.

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[197] The Act (sec. 2[illegible](d)(1)) requires that the certificates provide for a surrender value when the purchasers complete payments scheduled for the first year. For many years, the 15- and 20-year face-amount certificates of the largest company in this field had no surrender value until the first 7 months' payments had been made.

[198] Act, secs. [illegible]8([illegible]) [illegible]) (A) [illegible] ([illegible]) See also Act, sec. 28 (d).

[199] The other four registered face-amount certificate companies [illegible] their June [illegible], 1966, net assets are: Namoco Mortgage C[illegible], Inc. ($0.5 [illegible] million); Principal Certificate [illegible], Inc. ($0.[illegible] million); State Bon[illegible] & Mortgage Co. ($2[illegible].7 million); and [illegible] Funds, Inc. ($27.4 million).

[200] The payment experience on the remaining 148 certificates is not furnished [illegible] they were [illegible] (due t[illegible] [illegible]), [illegible] transferred to other certificates.

[201] Under the certificates then being issued, no cash surrender value was provided until 6 months payments or their equivalent had been made.

[202] Purchase[illegible] of certificates who had made 3 years' payments were entitled to a surrender value of 71 percent of the payments made.

TABLE V-6.—*Payments experience as of the end of 1961 for 2,000 Investors Syndicate of America face-amount certificates sold during July 1941 and January 1945* [a]

Certificates terminated:	
Canceled—Uncompleted sales, etc	126
Refunded—Death and disability clause	17
Transferred to other certificates	5
Lapsed before attaining cash value	310
Surrendered for cash value, to satisfy loans, or for conversion to paid-up or to optional-settlement certificates:	
Installments paid when surrendered:	
7 to 11 months	88
12 to 23 months	155
24 to 35 months	106
36 to 47 months	104
48 to 59 months	80
60 to 71 months	68
72 to 83 months	57
84 to 95 months	46
96 to 107 months	71
108 to 119 months	42
120 to 131 months	40
132 to 143 months	15
144 to 155 months	39
156 to 167 months	32
168 to 179 months	18
Matured	594
Total	1, 555
Total certificates surrendered	2, 013
Less certificates reentered	29
Total certificates terminated	1, 984
Certificates in force:	
Months cash value attained (no cash value below 7 months):	
7 to 11 months	-----
12 to 23 months	-----
24 to 35 months	-----
36 to 47 months	-----
48 to 59 months	-----
60 to 71 months	-----
72 to 83 months	-----
84 to 95 months	-----
96 to 107 months	1
108 to 119 months	1
120 to 131 months	2
132 to 143 months	-----
144 to 155 months	2
156 to 167 months	-----
168 to 179 months	10
Total certificates in force	16
Total certificates terminated	1, 984
Total certificates analyzed	2,000

[a] Series 1 certificates providing for 180 monthly payment units.

Source: Investors Diversified Services, Inc.

(c) Conclusions and recommendation

All of the reasons underlying the Commission's conclusions that front-end loads should be prospectively prohibited on the sale of contractual plans apply with greater force to this type of loading arrangement on face-amount certificate sales. Face-amount certificates are debt securities. They pay rates of return which are less than prevailing interest rates on U.S. Government bonds, savings and loan accounts, and interest-bearing bank deposits. Persons who purchase face-amount certificates and fail to complete most of the payments provided for cannot even hope—as can contractual plan investors—that rising security market levels will enable them to recoup the front-end load deductions.

The Commission believes that there is no justification for front-end loads in the sale of face-amount certificates. It would be anomalous to abolish front-end loads on future contractual plan sales but not on face-amount certificates. Should this course be taken, the highest effective sales charges in the securities industry will apply to the sale of debt securities.[203]

Accordingly, the Commission recommends that the Act be amended so as to prohibit the imposition of front-end load sales charges on the future sale of face-amount certificates. It also recommends that the maximum aggregate permissible sales load for such certificates be reduced from the present level of 7 percent to the 5 percent level that it considers appropriate for other types of redeemable investment company securities. Face-amount certificate purchases should not be more costly to investors than purchases of other investment company securities.

As in the case of the Commission's legislative recommendations respecting contractual plans, the above recommendations should not cause face-amount certificateholders to redeem or cease making payments on their certificates. The failure to complete a face-amount certificate plan almost always results in a loss to the investor.

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[203] Aside from face-amount certificates, debt securities have traditionally entailed lower sales charges than those involved in the sale of equity securities. It is noteworthy that in 1965, when IDS first offered a contractual plan subject to a front-end load of 20 percent, it increased to 80 percent the surrender value on its newly issued face-amount certificates. In effect this step brought sales compensation on its face-amount Certificates into line with that on its contractual plans.