personal expenditures, including medical bills and the repayment of other debts; these uses of the proceeds from redemptions were listed by only 25 percent of regular account redeemers.

Since the average redemption of a contractual plan took place within 3 years of its purchase, it is not surprising that most redeemers of contractual plans reported losses on their investments. The majority of those who liquidated their regular accounts, on the other hand, reported gains. It is also not surprising that a dominant majority of contractual plan redeemers reported that they had not accomplished their general investment objectives, while a slight majority of those who closed out their regular accounts thought they had. However, even among contractual plan redeemers who felt that they had not accomplished their general objectives there were a number who thought that the plans had provided some of their promised benefits, especially the encouragement of discipline in saving.

Among those redeemers who were dissatisfied, regular account redeemers emphasized matters of performance of their funds, while contractual plan redeemers emphasized matters relating to sales charges. A significant number of redeemers indicated that they had acquired information after their purchases which would have affected their original investment decisions. The later information emphasized by those who redeemed regular accounts included publications indicating better performance of other funds and "high management costs." Contractual plan redeemers primarily mentioned receiving information on sales charges: learning of front-end loads after the sale, of misrepresentation of sales charges, and of methods of acquiring fund shares without a front-end load. Of the 90 percent of redeemers whose plans had been liquidated before completion, only about one-half were aware that the effective sales charge they had paid was a greater percentage of their investment than it would have been had they completed their plans, and a quarter of these reported that they had not anticipated this effect when they purchased their plan.

The last section of the Survey contains certain highlights and implications to which the authors call attention, some of which relate to mutual fund investors generally while others relate to contractual plan holders.

As to mutual fund investors generally, the Survey concludes that the mutual fund industry seems to be meeting a demand for an equity instrument suitable for the investment of small and medium savings flows. A highlight of the Survey, it is stated, was the high expectations of purchasers with respect to the prospective investment performance of their funds. Part of this optimism the Survey attributes to general prosperity and the pervasive boom psychology of recent years, while part may be attributed to exaggerated emphasis on capital appreciation by fund salesmen. While stressing that comparable data are unavailable for investors in other types of assets, the Survey found a generally low level of knowledge by most mutual fund investors regarding their funds. In view of a number of indicia of lack of sophistication among purchasers of mutual funds, the Survey suggests that "additional safeguards may be required for the protection of investors in mutual funds."

As to contractual plan purchasers, the Survey notes that the proportion of purchasers increases with lower income and less skilled occupational status, and that contractual plan investors appear less informed

financially and to have higher expectations than mutual fund investors in general. The combination of high investor expectations, low levels of financial knowledge, and the special sales incentives associated with contractual plans, according to the Survey, tend to encourage purchases by many contractual plan investors for whom their appropriateness may be open to question, including particularly a substantial portion of purchasers with annual incomes of less than $5,000 and the significant minority of contractual plan purchasers who entered into plans while having no other financial assets.

6. SUPERVISION AND CONTROLS OVER MUTUAL FUND SELLING PRACTICES

The selling activities of salesmen for mutual fund retailing organizations are, like the activities of salesmen for other securities firms, subject to their own firms' internal supervisory controls and to external controls of the Federal and State Governments and the NASD (except for the salesmen of the few dealers that are not members). However, the particular nature of the large fund retailing organizations results in patterns of supervision and controls which are in many ways distinct from those which apply in the general securities business.

a. Supervision of salesmen

The importance in the mutual fund industry of a number of large retail selling organizations employing hundreds and even thousands of salesmen, sometimes spreading throughout the country, inevitably raises the question of the manner in which the activities of these salesmen are supervised. As has been noted,[88] broker-dealer firms are charged with the responsibility of supervising their salesmen under the Federal securities acts and the rules of the NASD, and failure to discharge this responsibility can involve sanctions, including revocation of a firm's registration. The law does not distinguish in this respect between firms which specialize in sales of fund shares and those engaged in a general securities business. However, the differences in the securities sold, the manner in which they are sold, and the nature of the sales organizations themselves make the problems of supervision different for mutual fund sales organizations, both in degree and in kind, and result in different approaches to the problems.

As in the case of the sale of securities generally,[89] certain recognized improper practices occur with sufficient frequency to justify particular attention. Of principal concern in the sale of mutual fund shares is high-pressure selling, which may involve misleading representations to customers and may result in the sale of mutual fund shares and contractual plans to persons for whom their purchase is unsuitable,[90] or in switching customers from one fund to another in order to earn a sales commission, thereby subjecting such customers unnecessarily to extra sales charges and possible capital gains taxes. Other improper activities of salesmen include the use of oral presentations, sales literature and letters which fail to comply with the Commission's Statement of Policy covering the sale of investment company shares, failure to deliver prospectuses, and recommendations that purchases be timed to take "advantage" of dividend or capital distribution of a fund.

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[88] See ch. III, p. 290 (pt. 1.
[88] See ch. III, p. 290 (pt. 1).
[89] See ch. III, pp. 296–299 (pt. 1).

It has been seen that a substantial portion of the sales forces of the large retail mutual fund sales organizations consists of new recruits with no prior securities experience and brief training, compensated exclusively by commissions on the sales they make. Most shares of mutual funds and particularly of contractual plans are made by fund salesmen operating alone in the homes and places of business of the purchasers.[91] From these circumstances alone it might be expected that the problems of supervision would be difficult.

As an initial step in encouraging compliance by their salesmen with the laws, regulations and ethical standards of the Commission and the NASD, most companies rely extensively on the hortatory approach. Advice, instructions and warnings on such matters are not only built into their training courses but repeated frequently in periodic sales meetings, sales manuals and publications regularly distributed to sales personnel. The primary concern of such meetings and materials, however, is increasing sales. While constant reminders of legal and ethical obligations to customers may serve an important function in an overall scheme of supervision, they are by their nature directed toward placing responsibility for compliance upon the salesman himself. Additional supervisory controls are required on the part of the firms themselves. Such controls as exist generally assume the form of field staff supervision and supervision by the home office.

(1) *Field supervisors*

In most large fund retailers there exists a hierarchical structure of field supervisors. Their titles and the nature of their duties vary from firm to firm, but they have several common characteristics. They are charged in varying degrees with responsibility for the proper conduct of salesmen under their supervision, but this is only one of their duties. They are primarily engaged in recruiting and training new salesmen, in stimulating sales, and in selling for their own accounts. Almost all of them are compensated exclusively by a commission system under which they earn commissions on their own sales and overrides on the commissions on sales of the salesmen they supervise.

The field supervisors of King Merritt & Co., Inc., illustrate the common pattern. In May 1962, the company had a sales force of approximately 2,200 salesmen operating throughout the 50 States of the United States and in several foreign countries. Like most other large firms, it has experienced a heavy turnover of salesmen. In 1961 it hired almost 1,000 salesmen and about the same number left the firm.

King Merritt operates through a regional structure consisting of 16 regions, which in turn are subdivided into 194 divisions. Each region is headed by a regional manager, and each division by a divisional manager. In large divisions the divisional managers may be assisted by district managers.

The key to the structure of field supervision in King Merritt is the divisional manager. Divisional managers are responsible for hiring, training, and supervising salesmen and for managing the divisional offices, some of which are located in divisional managers' homes. In addition the divisional managers since 1962 have been expected to review with the salesmen all sales made in their division before trans-

[91] See the discussion of the Mutual Fund Investor Survey in sec. 5, below.

mitting them to the home office, and they are required to receive, review, and maintain a file on the business correspondence of all their salesmen. However, most of them also continue to make sales of their own, and generally are compensated at the highest commission rates of their firm. Some of them are among the firm's leading salesmen. The number of salesmen subject to the supervision of individual divisional managers ranges from 3 to as many as 70, with an average of 12, but in the larger divisions the divisional managers are assisted in some of their hiring, training, and supervising functions by district managers.

Most divisional managers have had 5 years' experience with King Merritt and work full time for it. Ninety percent are recruited from the firm's own sales staff. They are compensated, as are most supervisory employees in mutual fund sales organizations, exclusively by commissions from their own sales and overrides on commissions from sales by the staff that they supervise. In spite of their supervisory responsibilities the principal source of income for most of them is commissions on their own sales, although the system of overrides gives them a significant incentive to increase the sales of those under their supervision.

King Merritt's regional managers are a relatively recent addition to its supervisory structure. Following several instances of inadequate supervision in its divisional offices, the company in 1961 assigned 16 persons to serve as regional managers. Regional managers are charged both with the supervision of the divisional retail offices in their regions and with the promotion of sales production by the salesmen attached to those offices. A regional manager visits each divisional office in his area at least once every 2 months' holds formal and informal meetings with the salesmen and submits inspection reports to the home office covering both matters of sales production and various supervisory matters. In the exercise of his supervisory responsibilities, the regional manager is expected to determine, for example, whether correspondence to customers complies with the SEC Statement of Policy, whether the sales literature in use is current, whether the divisional manager checks salesmen's kits to determine that they do not contain materials violating the Statement of Policy, and whether the managers and salesmen comply with various firm policies. The regional managers do no selling of their own, but are compensated on the basis of sales achieved by the divisional sales offices within their regions.

While a regional or divisional structure is common in large organizations, some of them rely less on their field supervisors and more on home office administration than is the case with King Merritt. One such organization is Investors Planning Corp. of America (IPC), which has five offices all located in the eastern part of the United States. A majority of its 4,700 salesmen work out of the company's main office in New York City. Responsibility for the supervision of this staff is divided between full-time administrative personnel in the home office and salesmen in supervisory positions, not all of whom work full time for the company. However, the duties of field supervisors are more limited than those of the divisional managers of King Merritt.

IPC field supervisors bear the titles of "career seniors," "supervisors," and "managers." IPC does not appoint supervisors from outside the organization, but a salesman is entitled to be promoted to

these levels on the basis of fixed standards of personal sales production, recruiting, and the aggregate sales of other salesmen recruited by or assigned to him, without regard to other personal qualifications.[92] For example, a career senior is automatically promoted to supervisor when he has recruited 10 salesmen, when 6 salesmen recruited by him or by his recruits have each made sales aggregating $125,000, and when sales aggregating $1,250,000 have been made by salesmen on whose commissions he receives overrides. According to testimony of Walter Benedick, president of IPC:

> * * * in order to develop six of his men to "advanced [status]" and in order to reach the minimum dollar volume of his entire group, it takes sometimes 3 or 4 years. By that time he is an oldtimer and an experienced man.

Although IPC has no formal requirement that its supervisors work full time, most do, since according to Benedick, "by the time they attain that position their rewards are such that they are glad to devote full time." Supervisors are in turn automatically promoted to managers after attaining specified production goals.

Nearly all of IPC's new salesmen receive their initial training from a full-time training staff in its home office, and are then assigned to the career senior who recruited them, or to a supervisor or manager. With respect to their going on calls with new salesmen, Benedick testified:

> It varies with the age of the career seniors, supervisors, and managers. There are no strict rules. It depends also upon the type of men. Some men don't need any of that assistance or checking. Others need more. It is not possible to establish or set a firm rule about that kind of procedure.

Career seniors, supervisors, and managers do not review each sale made by every salesman assigned to them, a process which is performed only by the home office.[93] They are expected to serve as the salesmen's advisers on selling practices and techniques, to check their oral presentations, and, according to Benedick—

> To help the men increase their knowledge [of] funds, to help the men keep up to date on rules and regulations, and help them to conform to all regulations. * * *

Partly because of the extent to which IPC relies on home office supervision, its ratio of salesmen to supervisors is higher than in other companies whose field organizations were reviewed by the study, but for the supervisors of most of the firm's salesmen the ratios appears to be so high as to give them little time, in addition to that taken by their own sales activities, for supervision of individual salesmen. In February 1962, IPC had 43 career seniors who, under the direction of 13 managers, were responsible for the supervision of 792 salesmen—an average of approximately 18 salesmen per career senior. A number of the career seniors serve part time and all of them engage in their own selling. Twelve supervisors who also engage in their own selling were solely responsible for the supervision of 821 salesmen, an average of nearly 70 salesmen per supervisor. IPC's 13 managers, who also make sales on their own in addition to overseeing the activities of 101 career seniors and 12 supervisors, were charged with direct supervision of another 2,126 salesmen, an average of 163 per manager. All career seniors, supervisors and managers are compensated on the

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[92] See ch. II, pp. 136–137 (pt. 1), on the qualifications of supervisors of mutual fund salesmen.

[93] The nature of IPC's home office supervision is discussed in the next subsection.

basis of commissions on their own personal sales and by overrides on the commissions of persons supervised by them.

The large 7,800-man sales force of Hamilton Management Corp. is similarly divided into 136 territorial districts, each in charge of a manager under whom there may be a number of assistant managers, and the ratios of salesmen to supervisors range from 12 to 1 to 15 to 1. In the opinion of the company's executive vice president and director of sales, the maximum number of representatives that can be adequately supervised by a district manager or assistant district manager is 20. These supervisors are not, however, required to serve full time, and an analysis of their compensation for the year 1961 suggests that a substantial number do not. About half of Hamilton's district managers earned less than $5,000 and its assistant managers' income averaged slightly less than $2,400, including in each case income derived from overriding commissions and commissions from their own sales.

(2) *Home-office supervision*

Supervision of salesmen by the home offices of mutual fund selling organizations consists generally of one of two types of activities. Since applications for purchases of fund shares and contractual plans are invariably processed in the home office of the sales organization, the administrative staff of that office is charged with reviewing application forms and other forms or letters which may be required for sales under particular circumstances, as further discussed below. Since reviewing such documents only enables one to detect problems appearing on their face, a few of the larger fund retailing organizations have supplemented their home office staffs with field investigators, also called "customer relations men." These investigators are salaried employees who travel in their company's sales territories and interview customers in person or over the telephone to ascertain whether salesmen's presentations have complied with the requirements of the Commission's Statement of Policy and with their company's policies.

For the most part, home-office review of sales applications contributes little to the control of sales practices. At IPC, for example, where individual sales are not expected to be reviewed by a salesman's field supervisor, the administrative personnel charged with approving applications simply check to see that all purchasers are over 21 years old, that they are not delinquent under a contractual plan previously purchased through IPC, and that the salesman is registered in the State where the purchaser lives. Since the application form requests only information as to the purchaser's name, home and business addresses, telephone number, occupation or profession, citizenship and date of birth,[94] the home office will ordinarily lack any facts as to the applicant's other security holdings, financial situation and needs upon which a judgment as to suitability under the NASD rule might be based.[95] However, when a number of early liquidations of contractual plans sold by one salesman come to the attention of the home-office staff, or when on the basis of test checks of the sales records of individual salesmen it appears that one man has sold a substantial

[94] Where application is made for an insured plan, the applicant must also supply limited information on his employer, his duties, and the state of his health.

[95] See NASD Rules of Fair Practice, art. III, sec. 2.

number of accounts which are delinquent, the individual salesman is called in by the home-office staff and the IPC field investigators may examine the type of selling the man does. IPC also requires that all salesmen's outgoing correspondence be submitted to the home-office administrative staff for review prior to mailing.

The application form used for contractual plans sold by First Investors Corp. (FIC) since February 1962 does request information directly related to suitability. The form states:

In order to avoid the adoption of plans by persons for whom they are not suitable, the applicant will please answer the following questions:

1. Are you presently employed?
2. Name of company.
3. Position held.
4. Date of birth.
5. Do you carry a bank account?
6. Do you carry life insurance?
7. Do you hold other investments?
8. Are you a U.S. citizen?
9. Do you possess sufficient reserves to meet any unexpected financial demand without having to terminate your plan?

Since the FIC form does not, however, provide the home office with information concerning the amount of the applicant's bank balances, life insurance, other investments, reserves or financial needs, it can rarely supply the FIC administrative personnel with the basis for an informed judgment of the suitability of a contractual plan sale.

Certain mutual fund sales organizations have developed specific administrative controls to curb particular mutual fund sales abuses. One of these abuses is the sale of an uninsured contractual plan to elderly people. Such a sale might in many cases violate the NASD rule on suitability,[96] since such plans generally contemplate reduction of the heavy front-end sales charge by payments extending over a long period of years. Salesmen for Renyx, Field are advised that the company prefers not to sell plans to persons over 55 years of age. However, since management feels that older persons may want to make such a purchase with accelerated payments, the home office is instructed to question any sale where the application reveals that the purchaser is age 63 or more. FIC instructs its salesmen that applications for uninsured monthly plans from persons over 60 will be accepted in the home office if the applicant initials the following legend written on the top of the application form:

It is my intention to complete this plan by age 70.

Some firms have also adopted specific administrative controls with respect to "switching," the practice by which a salesman induces a mutual fund shareholder to sell shares of one fund and invest the proceeds in shares of another so that the salesman can earn a commission. In addition to imposing unwarranted sales charges on a customer, switching can subject him to unanticipated and unnecessary capital gains taxes. Except in unusual cases, a switching transaction is analogous to "churning" or overtrading an account in listed or over-the-counter securities, and violates the NASD suitability rule. The NASD has brought several disciplinary proceedings involving switching.[97]

[96] NASD Rules of Fair Practice, art. III, sec. 2.
[97] See sec. 6.c.3, below.

One of the firms recognizing the impropriety of most transactions involving "switching" is Waddell & Reed, Inc. (W. & R.). It advises its salesmen:

It would be impossible to justify switching an income fund of one investment company to an income fund of another investment company and similarly it would be difficult to justify switching from an income fund of one mutual fund to a growth fund of another mutual fund unless we could show that the circumstances of the investor had changed so that he no longer needed an income, but logically needed a growth fund for his future.

The company requires, before accepting any mutual fund shares for liquidation and application of their proceeds in an investment in shares of another fund, that a letter in the purchaser's handwriting provide satisfactory reasons to indicate that the transaction is suitable in the light of his other investment holdings, his financial situation and his needs. Hamilton Management Corp. more flatly prohibits switching of mutual fund shares, and its home-office staff is instructed not to accept mutual fund shares in payment for a Hamilton contractual plan, although nonmutual fund securities are accepted in payment. Other sales organizations, like Waddell & Reed, require the submission of letters from the customers, but often these are form letters, and while most mention the existence of the sales charge on the new shares, few indicate that the possibility of capital gains taxes is a factor to be taken into consideration by the switching shareholder. One firm indicates that a redemption request suggesting that the proceeds would be invested in something other than mutual funds would precipitate an interview with the investor by a local office manager, while a change from one fund to another would involve only a disclaimer letter from the customer without such an interview.

The requirement of a customer's letter as a matter of administrative control can be effective only where the home-office administration is aware of the redemption of mutual fund shares by a purchaser. A number of selling organizations encourage their salesmen to transmit to the home office any securities for sale or redemption the proceeds of which may be used for investment in their funds. On the other hand, a salesman intent on switching a customer from one mutual fund to another need not insist that the old shares be surrendered for redemption to his employer. Even if he does, some doubt may exist as to the extent to which the switch, notwithstanding the customer's letter, was initiated and understood by the customer. In one NASD disciplinary proceeding where customer letters were interposed as a defense against a charge of switching, the district committee's decision noted:

In the opinion of the committee a member's responsibility goes further than to accept at face value letters of such nature which unquestionably were designed to permit switches from shares of one mutual fund to another. Transactions of such nature are seldom initiated by the plan owner. * * * The respondent made no investigation to determine the suitability insofar as the customers were concerned of the liquidation of the shares of one fund and the purchase of another fund with the proceeds. Even if the letters could be accepted at face value, in the opinion of the committee, the rules require ascertainment of the matter of suitability for the liquidation in circumstances such as this complaint, and this did not take place.

With few exceptions, responses to the Special Study questionnaires STS-1 and STS-2 indicate that, apart from limited home office administrative policies on switching and sale of contractual plans to elderly persons, few mutual fund retail sales organizations have spe-

cial controls relating to the suitability for purchasers of investments in mutual fund shares or contractual plans. A number of dealers suggest in their responses that they do not believe that suitability is a problem with respect to investments in mutual fund securities. To a certain extent the hesitancy of mutual fund share retailers to recognize questions of suitability may stem from a reluctance to identify the product which they sell with investment securities. To a question in STS–1 about the special measures taken to prevent recommendations of security transactions not suitable for a particular customer, Renyx, Field answered: "We don't have security transactions." Similarly, in the study's public hearings the following colloquy took place between the Special Study's chief counsel and the president of IPC, Walter Benedick:

Q. A person who has taken your course and has passed the [NASD] exam is now free to go to customers and sell the securities?

A. Not securities; mutual funds.

Q. A share of a mutual fund is a share of a corporation, is it not?

A. We don't look upon mutual funds as a security. We regard it as a packaged financial program, not a security.

Q. You do sell shares of a corporation, do you not?

A. A mutual fund consists or has in its fund or portfolio the shares of a corporation.

Q. You are selling the shares of an investment company?

A. Yes.

Q. And this is generally regarded as a security?

A. From that point of view you are right, Mr. Paul. Selling shares of an investment company, and therefore a security, in a certain sense.

A final administrative control in effect in a number of mutual fund retail organizations relates to salesmen's correspondence. A few companies have policies absolutely prohibiting letters from salesmen to customers, though the problem of enforcing such a policy suggests some difficulties, and the policy as a whole suggests more concern with what is written than with what is expressed orally. Other firms require clearance of all salesmen's letters to customers with the home office to insure that they comply with the Commission's Statement of Policy, though some provide an exception for form letters previously approved by the home office.

The limitations of the effectiveness of home-office review and administrative controls, as indicated above, have impelled a few companies to establish staffs of roving field investigators charged with checking on the extent to which salesmen are complying with regulatory and company standards. The size and duties of these investigation units vary.

Investors Diversified Services, Inc. (IDS), has a salaried staff of nine field representatives, called "customer relations representatives," who visit branch offices on an annual basis, spot checking customers of salesmen by personal or telephone interviews and reporting on whether certain disclosures and explanations were made to and understood by the customer. In 1962 these 9 investigators conducted 7,829 interviews of customers of 2,231 of the firms approximately 3,000 salesmen. Among the matters on which these customer relations representatives are expected to report are whether the customer understood that the securities purchased by them are not approved by the Federal Government, whether the salesman made comparisons with other types of investment and, if so, whether the provisions of

the Statement of Policy were complied with, whether a prospectus was delivered at the time of solicitation, whether any other sales literature was used, and, if so, whether it also complied with the Statement of Policy. Hamilton Management Corporation similarly has a staff of two persons who interview contractual plan purchasers. Among the questions asked of Hamilton customers are:

> If your first contact with Hamilton was through a representative, was he courteous, high pressure, well informed or not well informed on Hamilton?
> Was the sales charge method of deduction for purchasing a Hamilton plan thoroughly explained to you?
> Were you told that Hamilton was a long-term investment program and that an early liquidation of your program would probably result in a loss?
> Was the importance of making regular payments on your Hamilton plan stressed with you?
> Were any [promises of] guaranteed rates of return made to you concerning your Hamilton program?
> Were any promises made to you concerning the future value of your Hamilton plan?

IPC, like Hamilton, also has a two-man investigating staff charged with checking with customers on the presentations of salesmen, both on a regular basis and in individual situations where complaints come to the attention of management or it becomes aware of a high proportion of plan liquidations or delinquent accounts among customers of particular salesmen.

(3) *The 30-day refund privilege and notices to customers*

Customer interviews by home-office staff members will detect some instances of salesmen's making misrepresentations and violating the Statement of Policy, and undoubtedly have a deterrent effect on overeagerness and high pressure on the part of salesmen. For a considerable number of dealers responding to questionnaires STS–1 and STS–2, however, it is evident that in the sale of contractual plans they view the princpial controls over misleading representations or omissions in sales presentations to be the 30-day refund privilege accorded to new purchasers by plan sponsors who are members of the Association of Mutual Fund Plan Sponsors, Inc. (AMFPS),[98] and the various disclosures and warnings to customers in selling literature, receipts and other documents.

Under the AMFPS Code of Ethical Business Conduct each plan sponsor is required to afford each plan purchaser in writing—

> The unqualified right, without specification of reason, to receive, on written request therefor filed with the member within 30 days after such initial payment, a full refund of his initial payment.[99]

According to the AMFPS, 22 out of 50 contractual plan sponsors were members of that organization at the end of 1962.[100] The plans sponsored by these firms accounted for 66 percent of the agreed payments of plans on the sponsors' books at the end of 1962, and 70 percent of amounts already paid on such contractual plans. The 30-day refund privilege is not only intended to deter salesmen from making misleading statements or significant omissions in their sales presenta-

[98] AMFPS Code of Ethical Business Conduct, art. III, sec. 7. Some AMFPS members, including Hamilton and FIC, extend the privilege beyond 30 days. IPC, not an AMFPS member, as no 30-day policy but states that it makes a full refund when in its opinion the circumstances warrant it.

[99] The privilege is similar to the right given to plan purchasers under the laws of Kansas, Massachusetts, and North Dakota, as discussed in sec. 6.

[100] One member, Channing Service Corp., does not give notice of the 30-day refund privilege to servicemen who pay for their contractual plans by military allotment.

tions, but also to afford contractual plan purchasers who may have subscribed impulsively an opportunity to rescind the transaction. According to an officer of one plan sponsor, this opportunity enables purchasers to decide whether they will have the means and self-discipline to carry out the long-term contractual plan program. On the other hand, critics of the 30-day refund provision suggest that there should be no limitation to 30 days in the case of improper selling and that the refund privilege may in itself lead to improper selling practices, with salesmen using it to nail down a doubtful sale, relying on the purchaser's inertia to avoid the refund.

Data collected by the Special Study suggest that the percentage of plan purchasers who avail themselves of the 30-day refund privilege has been relatively low. Payment records for a systematic sampling of contractual plan accounts opened in nine large plans in February 1959, discussed in detail in section 7.g(1), below, indicate that 1.3 percent of purchasers of plans in that month from sponsors offering such a refund privilege availed themselves of it to obtain refunds in full.[101] On the other hand, the same sampling indicates that 6.5 percent of such February 1959 plan purchasers who were offered a refund privilege had made only the initial payment of their contractual plans, so that one out of five persons who made no subsequent payments availed themselves of the refund privilege, with the balance subject to the maximum penalty of the front-end load. In addition, the rates of subsequent redemptions prior to completion and lapses of payments by planholders, which are discussed in section 7.g, below, suggest that the 30-day refund privilege may be relatively ineffective in eliminating purchasers who lack the means or self-discipline to carry out the long-term contract program.

In addition to the 30-day refund privilege, some plan sponsors rely upon various written notices and warnings to plan purchasers to minimize improper selling. Each prospectus, which by law be delivered to a plan purchaser, is required on its cover and in its text to provide a clear statement of the impact of selling charges and the risks of contractual plan investing, but quite apart from the disclosure required in the prospectus, some sponsors include notices and warnings in their application forms, receipts and follow-up letters. The application form of Waddell & Reed, Inc., for example, sets forth the amount of sales commission which is deducted from installments subject to the front-end load and from subsequent payments. King Merritt's contractual plan application specifically refers the applicant to the prospectus for information on sales charges and maintenance fees, and the following statement appears immediately above the space for the applicant's signature:

> I further understand that a major part of these charges is deducted from the first year's payments and that early withdrawal from the plan will probably result in a loss to me.

As noted, the FIC application asks the applicant whether his reserves are sufficient to meet unexpected financial demands without terminating the plan, while the Hamilton contractual plan purchaser is required to sign a separate notice stating:

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[101] Information submitted by the AMFPS to the Special Study indicates that during the first 6 months of 1962, which were characterized by a declining market, the percentage of new planholders taking advantage of the refund privilege was slightly higher.

I have been informed and understand that such a program is not advisable unless the investor intends to continue the program, BECAUSE A LOSS IS LIKELY TO RESULT IF THE INVESTOR DISCONTINUES HIS PAYMENTS DURING EARLIER YEARS OF THE PROGRAM. [Emphasis in original.]

Some sponsors, besides sending the new planholder a receipt for his initial payment which allocates it to sales charges, custodian fees and investment, accompany it with a letter giving notice of the refund privilege (for AMFPS members) and further warning him of the importance of continuing payments on a front-end loan plan. FIC, indeed, has estimated that it provides the customer with 22 warnings, disclaimer statements, schedules of deductions or, cross-references to them in its contractual plan prospectus, application form, plan certificate, receipt and transmittal letter.[102]

The refund privilege may well discourage the salesmen of those firms which offer it from failing to describe the front-end sales charge on contractual plans, since a receipt which reflects the application of his initial payment to sales charges is received by the new planholder at or shortly after the time he is notified of the 30-day privilege. Other omissions or misrepresentations, however, though they may constitute violations of the Statement of Policy, are less likely to be uncovered or inhibited by the refund privilege and the customary warnings.

b. Federal controls

Federal controls over practices employed in the sale of mutual funds stem from three sources: the provisions of the Federal antifraud statutes,[103] the disclosure provisions of the Securities Act of 1933 [104] and the Investment Company Act of 1940,[105] and the provisions of the Investment Company Act requiring filing with the Commission of advertising material and sales literature,[106] which has given rise to the Commission's Statement of Policy frequently referred to above. The jurisdiction of the Commission under these statutes extends to all broker-dealers and investment companies registered with the Commission.[107]

(1) *Fraud statutes*

Although the antifraud sections of the Securities Act and the Exchange Act and the sections empowering the Commission to prescribe rules and regulations reasonably designed to prevent fraudulent, deceptive or manipulative practices apply to the sale of mutual fund shares and contractual plans as well as to the purchase and sale of other nonexempt securities,[108] administrative or court proceedings in which fraud in the sale of mutual fund shares is charged have rarely been instituted by the Commission under these sections. In 1953, the Commission instituted one of the few broker-dealer revocation proceedings relating primarily to abuses in purchases and sales of mutual fund shares. The Commission revoked the registration of

[102] The results of the Wharton School Mutual Fund Investor Survey discussed in sec. 5, below, suggest warnings, disclaimer statements, and schedules of deductions may not always be understood by plan purchasers.
[103] Securities Act, sec. 17(a); Exchange Act, secs. 10(b) and 15(c).
[104] Securities Act, secs. 7 and 10.
[105] Investment Company Act, secs. 24 and 30.
[106] Investment Company Act, sec. 24(b).
[107] Broker-dealers which operate solely within the borders of a single State are not required to register and in at least one instance a large retail selling organization, located in California, is not registered with the Commission.
[108] See ch. III, pp. 302–04 (pt. 1).

a broker-dealer firm [109] after finding that the firm and three individuals had willfully engaged in fraudulent and deceptive conduct in connection with the sale of mutual fund shares.[110] The gravamen of the action was the sale of shares of a number of mutual funds to an unsophisticated investor (an order of nuns) at prices slightly below breakpoints at which substantial savings in commissions were available. Thirty separate purchases were made in 1 year with an aggregate cost of more than $500,000. Twenty-six of the transactions were in funds which provided for reductions in the unit price to purchasers, as well as smaller concessions to the dealer, if purchased in amounts of $25,000 or over. Instead of advising the customer to take advantage of the $25,000 breakpoints the broker executed purchases in amounts between $23,400 and $24,900 on 10 different occasions. The Commission found that a relationship of trust and confidence had been developed between the customer and the broker, whose advice, in turn, was designed—

> * * * so as to deprive the customer of established and clearly available price benefits, in order to swell registrant's profits.[111]

Although the Commission opinion stressed the fiduciary nature of the relationship between the customer and the broker and the reliance of the unsophisticated customer on the broker's expertise, an identical result could have been obtained under the "shingle theory," [112] since the broker's duty to deal fairly with the public was clearly violated by its recommendations to purchase unsuitable amounts of fund shares and its omission to make material disclosures concerning price advantages to the customer. While the case involves only the acquisition costs of mutual fund purchases, the rules and statutes governing fraud in the sale of securities may also be applied by the Commission in situations involving such other abusive practices as churning, the making of unsuitable recommendations,[113] and the use of misleading high pressure sales presentations in the mutual fund field under the case law developed in connection with sales of other securities.[114]

(2) *Disclosure requirements*

The primary Federal controls for the protection of mutual fund investors have been the disclosure and reporting requirements of the Securities Act, the Exchange Act, and the Investment Company Act. Under the Securities Act, delivery of a prospectus to each mutual fund purchaser is mandatory, and every investor who purchases fund shares must be afforded an opportunity to obtain all relevant and essential information concerning the fund which the Federal statutes and rules require.[115] Failure to provide each purchaser with a prospectus which has been permitted to become effective by the Commission, or providing him with one which is materially false and misleading, constitutes a

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[109] *Mason, Moran & Co.*, 35 S.E.C. 84 (1953).
[110] Sec. 17(a) of the Securities Act, and sec. 10(b) of the Exchange Act and rules X-10B-5 and X-15C1-2 thereunder.
[111] *Mason, Moran & Co.*, supra at p. 94.
[112] See ch. III, p. 238 (pt. 1).
[113] The Commission has indicated in a review of disciplinary action by the NASD that a sale of investment company shares without making inquiries concerning the customer and his needs may constitute a violation of the NASD Rules of Fair Practice. *Boren & Co.*, Securities Exchange Act release No. 6367 (Sept. 19, 1960).
[114] See ch. III, pp. 302–04 (pt. 1).
[115] Securities Act, sec. 10, and regulation C thereunder; Investment Company Act, sec. 8, and regulation 8B thereunder.

violation of the Securities Act,[116] and subjects the seller to administrative,[117] civil and criminal action.

The information required to be disclosed in a mutual fund prospectus is specified in regulations promulgated under the Securities Act which incorporates certain disclosures required under regulations issued pursuant to the Investment Company Act.[118] These regulations are intended to result in the disclosure of all relevant and material information concerning the operation of the fund, its management and the nature of the securities being offered. To this end the prospectus must include, inter alia, information relating to: the investment policies of the fund; the diversification of assets; its underwriting commitments; the tax status of the fund and of distributions made by it; any pending legal proceedings which may relate to it; the number of its shareholders; an identification and statement of the remuneration of directors, officers and members of advisory boards; the existence of relationships among insiders, the fund and the investment adviser; the structure of its capital stock and long-term debt; the method of pricing its securities for sale, redemption and repurchase, and financial operations of the fund.[119]

In addition, in recognition of the complicated nature of an investment company prospectus, certain basic information is required to be presented in a manner intended to provide maximum exposure for the benefit of the investor.[120] Under this policy the sales load expressed as a percentage of the public offering price per share, and any redemption or repurchase charge made in connection with the redemption or repurchase of shares, are required to be set forth on the outside front of the prospectus. Furthermore, certain "Condensed Financial Information," [121] including the 10-year history of the fund's per-share income and capital changes, must be set forth not further back than the fifth page of the prospectus, and cannot be preceded by any other chart or table.[122]

For the purposes of the Investment Company Act, the offering of a contractual plan is regarded as the offering of a security distinct from the shares of the mutual fund in which the contractual plan certificates represent underlying interests. In the sale of a contractual plan, therefore, a separate prospectus for the plan must be delivered along with the prospectus of the underlying mutual fund, and must spell out in detail all significant relationships, contracts and arrangements of the contractual plan sponsor. In addition, the front-end sales charges are required to be conspicuously stated on the front cover of the plan prospectus along with a statement that early liquidation of interests in the plan is likely to result in a loss to the investor.

Despite the detailed disclosure required by mutual fund and contractual plan prospectuses, there is some reason to question their effi-

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[116] Sec. 5, below.

[117] *Managed Funds Incorporated,* Securities Act release No. 4122 (July 30, 1959).

[118] Securities Act, sec. 10, and Investment Company Act, sec. 8b, and rules and regulations promulgated under each section. Primary responsibility for administration of the disclosure requirements of the statutes rests with the Commission's Division of Corporation Finance, while the Division of Corporate Regulation is concerned with the regulatory aspects of the Investment Company Act.

[119] See forms S-5 and N-8B-1.

[120] Ibid.

[121] Required by item 12 of form N-8B-1 under sec. 8 of the Investment Company Act.

[122] Form S-5, sec. 1(C). Disclosure and presentation of information in a prospectus of a unit investment trust, including contractual plans, is covered under form S-6 under the Securities Act and form N-8B-2 under the Investment Company Act.

cacy as a protection against high-pressure sales tactics, in view of the large number of unsophisticated investors purchasing fund shares, and particularly contractual plans,[123] and the complexity of the prospectuses themselves. In contractual plan prospectuses, particularly, important information concerning the actual performance record of investors with respect to redemptions and lapses is not disclosed.

(3) *Selling literature and the Statement of Policy*

The Investment Company Act contains a specific provision making it unlawful for a mutual fund or contractual plan or any underwriter for such companies to use the facilities of interstate commerce to transmit—

> Any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors unless three copies of the full text thereof have been filed with the Commission or are filed with the Commission within 10 days thereafter. * * * [124]

Under this provision the Commission is in a position to examine selling literature used in the distribution of mutual fund shares and contractual plans, to assure that the pertinent provisions of the Securities Act [125] and the Investment Company Act are not violated.

In 1950, the increasing volume of selling literature used by issuers, underwriters, and dealers which appeared to the Commission to be materially misleading in many respects led the Commission, with the cooperation of the NASD, to undertake a study of samples of advertising and supplemental sales literature. The study, according to the NASD Manual—

> revealed the existence of many practices in connection with the use, form, and context of certain advertising and sales literature which, in the opinion of the Commission, might violate statutory standards, including provisions of the Securities Act of 1933 and the Investment Company Act of 1940.[126]

As a result the Commission, in cooperation with the NASD and after holding public hearings on the subject, issued its Statement of Policy—

> so that issuers, underwriters, and dealers may understand certain of the types of advertising and sales literature which the Commission considers may be violative of the statutory standards.[127]

In the Statement of Policy, which was amended in 1955 and in 1958, the Commission lists examples of representations in sales literature relating to mutual funds which, it states, "will be considered materially misleading hereafter." [128] Use of sales literature which includes representations proscribed by the statement can therefore result in the institution of administrative, civil, or even criminal action by the Commission against the offender. However, except for those organizations engaged in the sale of mutual funds which are not members of the NASD, administration of the statement has largely been left to the NASD, which consults with the Commission on matters of interpretation.[129]

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[123] See the discussion of the Mutual Fund Investors Survey, sec. 5, above.
[124] Sec. 24(b).
[125] See sec. 2(10) and sec. 10.
[126] NASD Manual, p. J–3.
[127] NASD Manual, p. J–3.
[128] Id., p. J–4.
[129] See sec. c, below.

The Statement of Policy emphasizes that it "does not attempt to cover all possible abuses," but the examples cited cover most types of material representation. For example, it states that it will be considered misleading to represent or imply a percentage return on an investment in shares of an investment company unless computed in a particular manner and stated for the most recent fiscal year or, if an earlier year is used, accompanied by a statement of percentage similarly calculated for all subsequent years.

Similarly it will be considered misleading to represent or imply an assurance that an investor will receive a stable, continuous, dependable, or liberal return or that he will receive any specified rate of return, or that his capital will increase, or that the purchase of mutual fund shares involves a preservation of value. It prohibits reference to Government regulation of mutual funds unless accompanied by an explanation that regulation does not involve supervision of management or investment practices or policies.[130] Some of the other subjects covered are custodial services, redemption, comparisons with other types of investment—such as Government bonds, savings accounts,[131] life insurance, or other securities—or with market indexes. Other subjects include performance charts and tables, dollar-cost-averaging, sales commissions, and costs of switching funds.

Although the statement effectively covers most misleading representations, certain clarifications and additions are needed. While it provides that it will be materially misleading to use any chart or table which tends to create a false or misleading impression as to any material aspect of an assumed or hypothetical investment, at present prospectuses do not reflect evidence of lapses and redemptions of contractual plan accounts prior to completion.

Similarly, the Statement of Policy does not require that tables or charts illustrating contractual plan programs in which the first year's installments have been prepaid furnish a comparison illustrating a situation in which the sum used for prepayments is instead invested in a direct purchase of shares of the underlying fund. In addition, the subsection of the Statement of Policy requiring that sales literature which is designed to encourage investors to switch from one investment company to another disclose to the customer the cost of the switch, fails to require disclosure of possible tax liabilities for capital gains which may result.

An interpretive problem which has arisen under the statement as well as under section 24(b) of the Investment Company Act concerns the scope of material included within the term "sales literature." The statement defines the phrase to include—

> Any communication (whether in writing, by radio, or by television) used by an issuer, underwriter, or dealer to induce the purchase of shares of an investment company. * * * Communications between issuers, underwriters, and dealers are included in this definition of "sales literature" only if such communications are passed on either orally or in writing or are shown to prospective investors or are designed to be employed in either written or oral form in the sale of securities.[132]

Under this definition sales kits and other training materials distributed to salesmen have generally been considered to be "selling

[130] See the discussion of the Mutual Fund Investor Survey in sec. 5, above.
[131] Ibid.
[132] NASD Manual, p. J-3.

literature" for purposes of determining compliance with the Commission's filing requirements[133] and the Statement of Policy. In a review of a recent NASD disciplinary proceeding, the Commission agreed with an NASD finding that brochures sent by a broker-dealer to prospective salesmen constituted sales literature where such brochures were "part of a campaign to sell mutual fund shares to his salesmen." In this case the Commission noted that:

> The literature in question, which was prepared by applicant in quantities ranging up to 4,000 pieces [i.e., copies], was sent to actual and potential salesmen who answered applicant's newspaper advertisements * * *. In 1958, applicant had about 194 salesmen located all over the world, of whom more than 95 percent had no previous experience in the securities business, and "sales training kits," sent to his salesmen included one or more of the four brochures.[134]

As indicated above, the Commission for the most part relies on the NASD to enforce compliance with the Statement of Policy by its members. With respect to selling literature filed by issuers and underwriters who are not NASD members, it has been the Commission's practice to deal informally with firms whose material is found to be objectionable. In most cases a telephone call or a staff conference with such firms has resulted in the correction of any defects in the material proposed to be or previously disseminated. Where substantial quantities of materially misleading information have been distributed, the Commission has insisted on the circulation of corrective material. To date, only this informal method of processing mutual fund selling literature has been used by the Commission, and no injunction or other proceedings have been instituted, although in some cases in which the firm was an NASD member the matter has been referred to that organization for further appropriate action. In the 12 months ended June 30, 1962, 2,477 separate pieces of sales literature prepared by underwriters or issuers were filed with the Commission's Division of Corporation Finance, of which 2,063 pieces were examined. Under the informal procedures used, there is no record as to the number of filings which were required to be modified, corrected, or withdrawn.

(4) *Detection and Enforcement*

Information concerning improper sales of fund shares and contractual plans comes to the attention of the Commission through inspection reports, public complaints, the NASD, and the processing of selling literature filed with it. As noted above, improprieties discovered through the last mentioned procedure are handled informally and/or referred to the NASD. Public complaints, an important source of information in connection with abuses in the sale of securities other than mutual funds,[135] have provided fewer leads to the detection of improper mutual fund selling practices. Most such complaints are referred to the appropriate regional offices, and are often handled informally at the regional level.

The Commission's regular broker-dealer inspection program, which is conducted through its regional offices under the general supervision of the Division of Trading and Exchanges,[136] and the investment company inspection program which is conducted under the Division of Corporate Regulation, provide the only systematic procedure to de-

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[133] Investment Company Act, sec. 24(b).
[134] *Ernest F. Boruski, Jr.*, Securities Exchange Act release No. 6376 (Oct. 7, 1960), at p. 3.
[135] See ch. III, pp. 304–305 (pt. 1).
[136] Id., pp. 305–306 (pt. 1).

termine compliance with Federal statutes and Commission rules relating to practices employed in the sale of mutual funds. However, the Commission's two inspection programs have not been geared to the detection of selling abuses. Broker-dealer inspections are concerned primarily with the financial condition of the firms inspected and their compliance with recordkeeping requirements, and even under the Commission's revised instructions to inspectors[137] the problem areas in mutual fund and contractual plan selling discussed are not generally examined. Even the practice of switching a customer from one fund to another would not usually be detected during a routine inspection of a mutual fund selling organization.

Although the investment company inspection program is concerned primarily with compliance with the regulatory aspects of the Investment Company Act, inspections of principal underwriters and integrated funds may give rise to discoveries of improper selling practices. It has recently become a part of the inspection routine to examine sales kits and other training aids to determine compliance with the Statement of Policy, to inquire into customer complaints and occasionally to interview customers and salesmen where it appears that improper practices may have been used. If the circumstances indicate that salesmen are engaging in high-pressure, misleading selling practices, the matter is referred to the Division of Trading and Exchanges for followup and appropriate action. At present at least four cases involving improper selling practices or inadequate supervision are under investigation or in proceedings before the Commission. The investment company inspection program is hampered by a lack of trained personnel; only the New York, Boston, and Chicago regional offices conduct inspections in their regions, and the rest are conducted out of the main Commission office in Washington, D.C., by a four-man inspection unit. However, the Commission appears to be placing greater emphasis on detection and enforcement with respect to mutual fund selling practices. At present investment company inspections are conducted on a 7-year cycle, but with added personnel such inspections will be increased to a 3-year cycle in the next fiscal year.

c. NASD controls

Under the existing scheme of Federal regulation and industry self-regulation the NASD is the only self-regulatory body with a significant role in the control of practices employed in the sale of mutual fund shares and contractual plans. The national securities exchanges have not, with minor exceptions, attempted specifically to regulate their members' activities in this area.[138] The membership of the NASD, however, includes almost all of the broker-dealers registered with the Commission which are engaged in the sale of mutual funds, with the conspicuous exception of certain large totally integrated mutual fund retail organizations which lack any economic incentive to become members.[139]

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[137] Ibid.

[138] As noted in ch. II, the NYSE permits limited registrants (those employees who have not yet qualified to be full-fledged securities salesmen) to sell mutual fund shares. In addition, the NYSE has recently limited the range of materials permitted to be issued as reciprocal business to, among others, mutual fund dealers. NYSE Guide, par. 2440A. See also ch. VI.I and pt. C of this chapter for discussions of reciprocal business.

[139] See discussion of mutual fund sales organizations in sec. 1, above.

(1) *NASD rules*

The provisions of the Exchange Act which require the NASD to have rules designed to prevent fraudulent practices, "in general to protect investors in the public interest," [140] and to provide for discipline of its members for violations of its rules,[141] provide the statutory basis for the application of appropriate sanctions to members who violate NASD rules in the sale of fund shares and plans. The Rules of Fair Practice of the NASD which have been adopted pursuant to these statutory requirements, and which are discussed in detail in chapter III [142] cover, among other practices, fraudulent selling,[143] churning or excessive trading [144] and suitability,[145] and require that members supervise their salesmen's activities.[146] In addition to these rules of general application, article III, section 26 of the Rules of Fair Practice, the "Investment Trust Rule," which was promulgated under the authority of section 22 of the Investment Company Act, specifically deals with mutual fund discounts, unfair sales charges or commissions, and minimum offering prices to be charged by underwriters and dealers.[147] The NASD has also established other specific standards in the form of policies and interpretations to govern the preparation and use of mutual fund sales literature and advertising in accordance with the Statement of Policy, as well as certain ethical requirements relating specifically to mutual fund selling practices of underwriters and dealers. [148] For example, it has established a policy against "selling dividends" to discourage the practice of representing to investors that they gain an advantage by purchasing mutual fund shares shortly before an ex-dividend date, when in fact no such advantage accrues.[149] Members who fail to comply with these standards may be found to be in violation of the association's Rules of Fair Practice and particularly its basic rule, section 1 of article III, which requires that—

> A member, in the conduct of his business, shall observe high standards of commercial honor and equitable principals of trade.

(2) *Disciplinary actions*

In NASD disciplinary actions based primarily on improper practices in the offer and sale of mutual fund shares, four types of problems occur most frequently: violations of the Statement of Policy, selling dividends, recommendations to switch funds, and failure adequately to supervise salesmen.

By far the greatest number of cases involve violations of the Statement of Policy in the distribution of misleading selling literature to members of the public, usually without compliance with the association's filing requirements for such materials. In the period January 1959 through April 1962, approximately 50 disciplinary proceedings decided by the NASD involved Statement of Policy violations. In almost every case in which violations of any kind were found in connection with the sale of mutual funds, the respondent had also

[140] Sec. 15A(b)(7).
[141] Sec. 15A(b)(8).
[142] Ch. III, pp. 308–313 (pt. 1).
[143] Art. III, sec. 18.
[144] Art. III, sec. 15(a).
[145] Art. III, sec. 2.
[146] Art. III, sec. 27(a).
[147] NASD Manual, p. D–14.
[148] NASD Manual, p. J–1.
[149] NASD Manual, p. G–56.

disseminated literature in violation of the statement. During the period studied, violations of the Statement of Policy were found with respect to all types of firms engaged in the sale of fund shares or contractual plans, including large mutual fund selling organizations, fund underwriters, small retail broker-dealers and large NYSE wire houses.

A determination as to whether or not a member has violated the Statement of Policy may turn on the definition of sales literature. The NASD requires that its members file—

> All sales literature prepared by (or especially for) them, including all newspaper, radio or television advertising or scripts and all postal cards, form letters, and individually typed sales letters which repeat the theme of the same central idea.[150]

There is no express reference to sales kits or other training material in the material required to be filed with the association, nor in the definition of "sales literature" which appears in the statement. However, in at least one disciplinary case the NASD has indicated that sales and training aids must conform to the Statement of Policy.[151]

A second significant selling abuse figuring among NASD disciplinary actions involves the practice of switching the investor from fund to fund, with the investor being charged the sales load on each purchase. The Statement of Policy specifically requires all selling literature designed to encourage investors to switch from one mutual fund or class of mutual fund shares to another to contain the following statement:

> Switching from the securities of one investment company to another, or from one class of security of an investment company to another, involves a sales charge on each such transaction, for details of which see the prospectus. The prospective purchaser should measure these costs against the claimed advantage of the switch.[152]

However, since selling literature is not always involved in switching and disclosure is not necessarily an adequate protection for the unsophisticated investor, NASD control of the practice is based on its suitability rule [153] and on the general ethical standard of "just and equitable principles of trade." [154]

The disciplinary cases decided by the NASD indicate the type of switching activity which can occur. In one action involving a member with a large network of offices engaged in selling only funds and plans, one of its registered representatives was found to have switched a single investor from the three classes of fund shares he held to three others in less than 1 year. Although the salesman claimed to have known the financial needs of the investor and to have acted in his best interest, the Board of Governors approved a district committee finding that neither the salesmen nor the member had reasonable grounds for believing that the recommendations were suitable on the basis of the financial situation and needs of the investor.

The association has held the suitability rule to be violated in other instances of switching even when the member was able to produce letters from each investor stating in substance that he had asked for the change and understood that there would be an additional sales

[150] NASD Manual, p. J–1.
[151] See *Ernest F. Boruski, Jr.*, Securities Exchange Act release No. 6376 (Oct. 7, 1960).
[152] NASD Manual, p. J–14.
[153] Rules of Fair Practice, art. III, sec. 2.
[154] Id., art. III, sec. 1.

acquisition cost. In disposing of one such defense based on acquiescence, if not affirmative selection, one district committee stated:

The committee approaches and analyzes the facts from the standpoint of businessmen engaged in the securities industry. Individual respondents may be sincere in their contentions that no acts or recommendations of theirs precipitated the exchanges in customers' account, but if such is the case, the committee is unaware of the practicalities and realities of securities transactions. Sophisticated investors often initiate transactions on their own volition, but this is not true with a majority of the public, particularly unsophisticated persons. Brief descriptions of the accounts * * * show that the customers were of the unsophisticated type and under normal circumstances would not by their initiative exchange one mutual fund for another.

In another case in which a similar defense was offered, the district committee observed:

Transactions of such nature seldom are initiated voluntarily by the shareholder.

The board of governors, in affirming this district committee's fine and censure of the member, stated:

The committee noted that a member's responsibility is far greater than to accept such letters at fact value and that respondent did not fulfill its responsibilities in approving such transactions * * *.

The letters from the customers indicated that they were satisfied with their purchases, had initiated them, and that fines imposed against respondent were, therefore, unwarranted. We do not find that these letters exonerate the respondent from responsibility.[155]

A third major cause of NASD disciplinary proceedings is the practice of "selling dividends." A review of the NASD decisions suggests that fund salesmen may often urge a prospect to purchase fund shares prior to the ex-dividend date to take advantage of the dividend which is about to be declared and without disclosing that the imminent distribution of the dividend is reflected in the net asset value of the fund shares. Not only will the investor fail to derive any benefit from an ex-dividend purchase, but in fact, the purchase may be a disadvantage, since the dividend is taxable to the recipient as ordinary income.

The sense of urgency in a salesman's advice to purchase fund shares because of an impending dividend as well as the confusion easily created in the mind of an unsophisticated investor is demonstrated in letters to customers found by the NASD in two recent cases to be in violation of its rules. One letter said:

I still am convinced that it would be a smart move on your part to buy another 100 shares of Institutional Growth Fund while the market is still off. I would like for you to consider this in the light of the following fact. I know you would like to go ahead and get your interest on First Federal Saving, January 1. The Institutional Growth Fund goes ex-dividend January 1, and will be payable February 1. We could send in your order the last week in December and you would not have to pay for it until after January 1, thereby getting your January 1 dividend on February 1 from the Fund.

[155] These recent cases are in marked contrast to a 1961 district committee decision on switching. In that case a review of a member's correspondence files revealed some 43 letters from customers requesting or authorizing the switching of mutual funds in their accounts in an aggregate amount of $250,000. Some of the customers' letters were dated after the transactions took place, and in 18 of the 43 instances no reasons for the switches were given, in contravention of the firm's policies. The district committee found that:

"There apparently was no special attention given to these letters by the supervising officers, but rather they were filed as a matter of routine, and it was not customary to check back with salesmen."

The firm contended that it actively supervised its salesmen and its answer to the complaint included explanations for the transactions executed by the salesmen. No hearing was held on the matter and on the basis of the allegations and answer the complaint was dismissed.

I would recommend to you that you let us place this $3,000 investment prior to January 2, 1957, as dividends are being credited to stock as of record this date in one of the three funds. Your money can remain where it presently is so that you can receive dividends that may be credited as of December 31 or January 1. Our New York office will not invoice you for payment until about January 5. At this time you may remit, however, in the meantime we have picked up this dividend for you.

Here's an opportunity to pick up a quarterly dividend on an excellent investment. The current price is $11.32 (October 31 market close) and the dividend of 22¢ is an approximately 8 percent annual basis. Prospectus is enclosed * * * and we can put you on record at any time before 12 noon Wednesday.

If you had bought last week at $10.03 you would have your dividend covered even if it drops 17¢ after dividend date.

The district committee concluded—

That the statements contained in the correspondence clearly made use of impending dividends and distributions as an inducement for the purchase of investment company shares without giving full explanation and disclosure as to the effect of the dividend or distribution.

In many of the cases involving organizations engaged in selling mutual fund shares and contractual plans, the association also finds that the member firm has failed adequately to supervise the activities of its registered representatives. In one switching case the district committee in its decision made the following comment about the Michigan-based firm which was involved:

Obviously the respondent's president had operations, particularly in Florida, which were difficult to supervise. Surely he was or became fully aware of the dangers and hazards, because the Florida operations were discontinued.

In another case involving failure of supervision in a branch office of one of the largest retail mutual fund selling organizations, salesmen were found to have disseminated misleading sales literature in violation of the Statement of Policy, switched customers out of fund shares in violation of the suitability rule, and engaged in the practice of selling dividends. The district committee rejected the firm's answer that it had furnished each new employee with a copy of the Statement, with a booklet setting forth rules governing sales activities, and kept each registered representative abreast of all new regulations, interpretations, and rules. It observed that—

While the above steps, methods, and procedures, as a whole, are somewhat impressive, we cannot help overlook the fact, as clearly illustrated in the several answers submitted by the respondents as well as testimony given at the hearing, that the respondent member at no time during the period alleged, either upon occasional visits or otherwise, made itself aware of the contents of the branch office correspondence files.

Therefore, on the record, we are convinced there is no question but that the respondent member failed and neglected to supervise such correspondence in contravention of section 27 of article III of the Rules of Fair Practice.

(3) *Administration, detection, and enforcement*

The primary responsibility for the administrative and policymaking functions of the NASD in the field of mutual fund underwriting and distribution are vested in the Investment Companies Committee of the association, which is composed of seven members from the mutual fund segment of the industry. The committee and the NASD staff exercise surveillance over the association's enforcement of the Statement of Policy and the investment trust rule, and formulate recommendations with regard to industry problems including fund-selling practices.[156] On the operating staff level, the Investment Com-

[156] See ch. XII.G for a detailed discussion of the work of this committee.

panies Department, which consists of the committee secretary, two assistants, and a stenographer, has the task of reviewing investment company sales literature and advertising material to determine whether it complies with the Statement of Policy.[157] The routine review of this material and the preparation of comments is now carried on primarily by the secretary's two assistants, who devote approximately 90 percent of their time to this function. In 1961 over 10,000 pieces of literature prepared by dealers or underwriters who were members of the NASD were filed with the department, of which approximately 4,700 required comment by this group.

In processing the vast amount of material, the Investment Companies Department, like the Commission, relies primarily on informal methods to enforce compliance with the Statement of Policy. Since an estimated two-thirds of the literature handled by the department is filed before use, a letter of comment will normally be sufficient to clear up objectionable material.

The filing requirements, generally speaking, only apply to materials that are reproduced for public dissemination or "individually typed sales letters which repeat the theme of the same central idea." There is at present no procedure for determining whether all such sales literature is actually filed with the NASD national office. One fund distributor told the study that, although it had submitted certain drafts of proposed materials to the NASD for comment, it had not in any instance filed literature after publication. Checks of members' literature files are made by NASD inspectors about once every 3 years.

The NASD's detection of improper mutual fund sales practices, other than Statement of Policy violations, is accomplished through the methods previously discussed in chapter III.B: The association's inspection program carried on locally by the district offices, public and industry complaints; and references from the Commission or other regulatory agencies. The principal approach to detection of such practices is the NASD's regular inspection program, which is presently operating on a 3-year cycle and generally emphasizes compliance with recordkeeping and financial requirements. High-pressure techniques by a selling organization, such as the practice of selling dividends, are not susceptible of detection by inspectors unless the improper representation is committed to writing and happens to be examined by the inspector.

However effective the NASD may be in detecting improper mutual fund selling practices, the penalties which it imposes are rarely severe. For example, in one case in which it was found that a firm had committed 187 violations of the Statement of Policy covering a 4-year period, failed to supervise salesmen, and committed numerous other violations, the firm was censured and fined $500. Another firm was fined $200 after a finding that its selling literature was misleading and included 111 Statement of Policy violations. In still another instance, a firm which was found to have violated the Statement of Policy, failed to file selling literature, used the practice of selling dividends, and failed to supervise its employees, was fined $100. On the other hand, where one member was charged with a single sale of

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[157] See ch. XII.G for fuller discussion of the operations of this department.

investment company shares below the public offering price, he was fined $400.

d. State controls

A number of varying types of controls over mutual fund selling practices and sales literature have been adopted by certain States, designed, in large measure, to regulate the sale of front-end-load contractual plans. They range from outright prohibitions against the sale of contractual plans to various disclosure requirements. Their scope is by no means universal, however, and many States have no special controls relating to selling mutual funds.[158]

Sale of contractual plans is prohibited or sharply limited in at least seven States.[159] This prohibition normally is based upon an interpretation by State authorities of a State statute or regulation limiting the commissions and expenses in an underwriting to a certain percentage of the proceeds or selling price. In the case of Iowa, for example, the securities law prohibits commissions, including expenses, in excess of 20 percent of the purchase price of securities. This provision has been interpreted to prohibit front-end loads in the sale of contractual plans on the ground that each payment under the plan constitutes a separate transaction and deduction of the normal initial commission would constitute a violation.[160]

Wisconsin, by rule, has limited the commission or load on the sale of shares to 8½ percent.[161] Acting under general statutory authority, furthermore, the State Department of Securities has forbidden the sale of contractual plans on the ground that front-end loads are "contrary to public policy and against the public interest and interest of investors." [162]

Other States impose specific maximum limits on commissions which may be paid with respect to mutual fund shares. Utah, for example, limits commissions and expenses on sale of securities generally to 20 percent of the proceeds. Commissions of not more than 10 percent are permitted for "investment trust" offerings, however, and commissions are not allowed on unpaid subscriptions, but "only as cash is actually received from subscribers." [163]

Michigan, whose Corporation and Securities Commission has in effect refused to qualify the sale of mutual fund shares through front-end-load plans, requires that commissions on the sale of securities not exceed 10 percent. For securities sold by installment payment over a period of more than 1 year, the commission may not exceed 20 percent of accumulated payments in the case of contractual plans and of securities for which the maturity value is not fixed. The limit is 5 percent when the maturity value is fixed.[164]

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[158] In general, State blue sky laws and regulations of course govern the sale of mutual funds, as well as of all other securities sold within the State. See ch. III, pp. 322–323 (pt. 1).

[159] California, Illinois, Iowa, Michigan, New Hampshire, Ohio, and Wisconsin.

[160] Iowa Code, sec. 502.8.

[161] Regulations, Wisconsin Department of Securities, rule 2.03.

[162] The State Department of Securities has indicated that its position is based upon Wisconsin Statute, chapter 189, sec. 13(3) (a), (b), (e), and (f) and 13(6), as well as rule 2.03.

[163] "Instructions for Issuers," Regulations, Utah State Securities Commission. It would seem that these regulations, like the law of Iowa, would prevent the sale of contractual plans with substantial front-end loads.

[164] Under the authority of the Michigan blue sky law, act 220, P.A. 1923, as amended, secs. 3, 12, and 13(1) and Michigan Administrative Regulations, sec. 19.I.

Two States have adopted disclosure requirements in connection with the sale of contractual plans. The required disclosures themselves are no greater than those of the Commission; these States do require, however, that disclosures be made in such a manner that information which is contained in the prospectus is highlighted. Thus, under the regulations of the Pennsylvania State Securities Commission, no contractual plan may be offered unless the prospectus is accompanied by other literature which contains the following information: That there may be profits or losses on portfolio transactions; that there is no guarantee of value at maturity; and that early termination usually will result in a loss. All sales charges and deductions must be specified and the terms of insurance policies issued in connection with the plan must be described. Pennsylvania also forbids dealers to publish literature containing hypothetical calculations of future performance based upon past performance.[165]

Kansas similarly requires disclosure of pertinent information to contractual plan purchasers. A periodic payment plan certificate must contain, or have attached, a schedule of all deductions from payments and a description of the terms of the plan and duties of the holder and sponsor, issuer, custodian or trustee. Furthermore, when a periodic payment plan certificate is issued, either a prospectus or separate statement showing the sales load and deductions to be taken from each installment payment must be sent to the planholder, as well as a duplicate copy of the application signed by the holder. A letter from the sponsor, issuer, custodian or trustee must accompany the statement or prospectus specifically pointing out the sales load, fees and other charges and informing the purchaser of his right to redeem without loss for 30 days.[166]

The requirement that contractual plan purchasers be given a 30-day redemption period has been adopted by North Dakota [167] and Massachusetts,[168] in addition to Kansas, as a control on the sale of contractual plans. This requirement has been adopted in the Code of Ethical Business Conduct of the Association of Mutual Fund Plan Sponsors, Inc., which represents many of the largest contractual plan distributors in the country.

Finally, a number of States either require that selling materials for mutual funds and other types of securities be filed for approval prior to use, or simply that they be filed either concurrently with, or prior to, their use.[169]

7. THE SPECIAL PROBLEMS INVOLVED IN CONTRACTUAL PLANS

a. History of contractual plans

In the area of mutual funds, few matters have aroused more controversy than contractual plans. Congress has singled them out for special regulation.[170] Their sale has been limited or prohibited by

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[165] Regulation 1400, Pennsylvania State Securities Commission.
[166] Art. 4, sec. 81–4–2, Regulations, Kansas State Securities Commission.
[167] Condition placed on the registration of contractual plan securities by the commissioner of securities under the authority of North Dakota Century Code, sec. 10–04–08.1.
[168] Massachusetts General Laws, ch. 110A, sec. 11C.
[169] See, for example, Minnesota Statutes, ch. 80, sec. 18; Cal. Adm. Code, title 10, ch. 3, art. 24, sec. 641; Texas Securities Act of 1957, sec. 22.
[170] Investment Company Act of 1940, secs. 24(c), 26 and 27.

seven States.[171] Yet they have been one of the fastest growing investment media in the last decade. Their growth and the manner in which they are sold raise significant questions.

Contractual plans were first offered to the public in 1930. Their number mushroomed from 5 companies offering them in that year to over 40 by 1936. In 1935 Congress directed the Commission to study the functions and activities of investment trusts and investment companies.[172] The Commission's report, which was one factor leading to the adoption of the Investment Company Act of 1940, found many problems to exist, particularly with respect to selling practices and excessive sales charges. Total loading charges on completed contractual plans in some cases amounted to 20 percent of the amount invested, and averaged 13.39 percent of total plan payments. Usually, all of the first year's payments were deducted for sales load and other charges, which left the plan purchaser with little or no investment if he redeemed his shares at an early stage. Contractual plans were sold to many subscribers for as little as $5 a month, and a relatively large proportion of purchasers in that category sustained heavy losses through early redemptions. These were the main factors that led to the enactment of section 27 of the Investment Company Act, which, in addition to limiting the sales load to 9 percent of the total proposed payments on contractual plans (the only specific limit on sales charges imposed by Congress), provided a formula limiting deductions for sales charges so that they would not exceed 50 percent on the first 12 installments or their equivalent.[173]

The sale of contractual plans declined following the enactment of the Investment Company Act of 1940. All but 5 of the 40 companies selling the plans abandoned this phase of the securities business, and no great increase in contractual plan sales took place during the 1940's. As recently as 1956, only about a dozen mutual funds were offered to the public on a contractual plan basis. However, the last few years have been marked by a resurgence of the contractual plan industry, stimulated by aggressive and intensive sales activity. At the end of 1962 the shares of 63 mutual funds, including some of the oldest and largest in the country, could be purchased through contractual plans.

The great increases in sales of contractual plans in recent years have contributed to the rapid growth of the open-end investment company industry. At the end of 1949 total proposed payments on outstanding contractual plans were $93 million, one-third of which had been paid. By the end of 1961 there were about 950,000 contractual plan accounts outstanding which provided for total proposed payments of $4.6 billion, of which over $1.5 billion had been made. Contractual planholders owned roughly 6.6 percent of the $22.8 [174] billion of mutual funds' total assets at that time. This small percentage in part reflects the fact that the major growth of contractual plan sales has oc-

[171] See sec. 6.d above.
[172] Sec. 30 of the Public Utility Holding Company Act of 1935.
[173] Sales charges must be apportioned evenly on payments 1–12, inclusive, and the balance of the sales charge remaining after such payments must be spread equally over the balance of the plan payments. Although sec. 27(a)(2) of the Investment Company Act provides that no "more than one-half of any of the first 12 monthly payments thereon, *or their equivalent*" may be deducted for sales load, the Commission is authorized by sec. 27(b) to relax these provisions under certain circumstances. In recent years sponsors have been permitted to apply the front-end load to a 2- or 3-installment initial payment with the result that the front-end load now usually applies to 13 payments or their equivalent.
[173] See ch. I, table I–20.

curred within the last few years [175] and in part the relatively small size of the monthly payments that are made on contractual plans. A more important measure of the impact of contractual plan sales on the investing public may be found in the conservative estimate that more than one-fourth of the 2.6 million persons investing in mutual funds are doing so through contractual plans.[176]

b. Basic elements of the contractual plan

A contractual plan is essentially a long-term program for investing in shares of an open-end mutual fund on an installment basis.[177] The plan is characterized by the deduction of about 50 percent of the first 12 (or 13) installments for sales charges, a feature commonly referred to as the "front-end load."

Shares of an open-end investment company are only indirectly purchased through contractual plans. The security directly purchased is a "periodic payment plan certificate," [178] which represents an undivided interest in, rather than direct ownership of, shares of an open-end investment company known as "the underlying security." [179] The contractual plan certificates are sold to investors by principal underwriters (known in common usage as "sponsors" or "plan companies") and by broker-dealers. Plan companies, unlike fund sponsors, are sometimes not affiliated with the investment adviser or the principal underwriter of the fund, and the plans themselves are deemed to be investment companies under section 3(a)(3), 3(c)(6) and 27 of the Investment Company Act of 1940. The certificates which they offer are registered under the Securities Act of 1933.

Contractual plans usually call for monthly payment of a specified amount over a predetermined period, ranging from 5 to 25 years. Most common is the 10-year, 120-payment plan, but some of the larger plans call for 100, 150, 180, or 200 monthly payments over periods of 8, 12½, 15, or 16⅔ years. The size of each scheduled monthly payment or installment ranges from the $10 minimum fixed by the Investment Company Act [180] to $2,000. Contractual plans are often designated by the size of these scheduled installments, e.g., as the $25-monthly-payment plan, $50-monthly-payment plan, etc.

The sales load on a completed contractual plan (where all payments are made) usually amounts to 8.5 percent of the total payments called for, or 9.3 percent of the total amount to be invested. The amount varies from plan to plan, and all plans provide for a reduction of the sales charge for plans with higher denominations, such as $50- or $100-monthly-payment plans. The most frequently sold denomination is the $25 plan. On this and lower denomination plans the charge

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[175] In 1962 for example, contractual plans accounted for 13.5 percent of the total purchases of investment company shares.

[176] The Investment Company Institute has estimated that at the end of 1961, the 5,391,201 shareholder accounts reported to it by member companies represented 2.6 million individual shareholders. Even allowing for substantial duplication among the 950,000 contractual plan accounts—and it is unlikely that many persons simultaneously make payment on two uncompleted contractual plans—it would appear that more than 25 percent of the estimated 2.6 million individual fund shareholders have made their investments through contractual plans.

[177] Another method of investing in investment company securities on an installment basis is through the purchase of face-amount certificates. See Investment Company Act, sec. 4(1).

[178] Investment Company Act, sec. 2(a)(26).

[179] The underlying securities purchased with the proceeds of payments on the contractual plan are usually shares of a managed fund, although in a few instances they are shares of a fund with a portfolio of specified securities, eliminating portfolio management. See Investment Company Act, secs. 2(a)(26) and 4(2).

[180] Sec. 27.

ranges from about 7.5 percent to 8.98 percent, only slightly less than the 9-percent limit provided in the Investment Company Act.

The front-end load is a method of paying a large portion of total sales charges in advance. From each of the first 12 (or 13) installments under the plan there is deducted up to 50 percent as part of the total sales load to be paid on all of the proposed payments. In relation to the total sales load to be paid, the 50 percent of installments 1 to 12 so deducted will constitute from one-half of the total plan sales load to as much as 80 percent in one case. For example, on a 10-year, $25-monthly plan ($3,000) with a total sales load of 8 percent ($240), the 50-percent deduction from the first 12 payments equals $150, or 62.5 percent of the total charge. Expressed as a commission or markup, the sales load on the first 12 or 13 payments usually is equal to 100 percent of the amount from those payments actually invested. In addition to the 50-percent sales load, a custodian's fee of 1 to 3 percent of each payment is usually also deducted, so that less than one-half of the first installments paid by the investor is available for investment on his behalf. Since a major portion of the total sales load has been paid on the first installments, the sales load on remaining installments is considerably less, varying from about 1.6 percent to 5.0 percent of each payment. The actual percentages in individual cases depend upon both the total number of payments and the cumulative average sales load on the entire plan.

Although, as indicated, there are a number of variable factors, the following table is reasonably typical of the normal relationship between sales charges and amounts invested for a $25-monthly, 10-year plan:

TABLE XI–c.—*Distribution of payments at various stages of $3,000 ($25 monthly) 10-year contractual plan without completion insurance*

	Amount of payments [1]	Sales charge [2]	Custodian fee	Total net amount invested
Total amount of 6 payments (6 months)	$ 175.00	$ 87.50	$ 3.50	$ 84.00
Percent of amount of 6 payments	100.00	50.00	2.00	48.00
Total amount of 12 payments (1 year)	$ 325.00	$162.50	$ 6.50	$ 156.00
Percent of amount of 12 payments	100.00	50.00	2.00	48.00
Total amount of 24 payments (2 years)	$ 625.00	$172.70	$12.50	$ 439.80
Percent of amount of 24 payments	100.00	27.63	2.00	70.37
Total amount of 36 payments (3 years)	$ 925.00	$182.90	$18.50	$ 723.60
Percent of amount of 36 payments	100.00	19.77	2.00	78.23
Total amount of 48 payments (4 years)	$1,225.00	$193.10	$24.50	$1,007.40
Percent of amount of 48 payments	100.00	15.76	2.00	82.24
Total payments to be made for completion of plan	$3,000.00	$253.50	$60.00	$2,686.50
Percent of total payments for completion of plan	100.00	8.45	2.00	89.55

[1] With required initial payment of 2 installments.
[2] 50-percent sales charge on first 12 payments (13 installments) and 3.4-percent sales charge on subsequent installments.

The foregoing method of purchasing mutual fund shares has various names, "contractual plan." "periodic payment plant." "periodic investment plan," "systematic accumulative plan," and "systematic investment plan." The best known is "contractual plan." The method of deducting a large part of the sales charge from the first installments for contemplated future payments also has led to the use of such names as "prepaid charge plan," "penalty plan" and the "front-end-load plan."

Some of these shorthand designations are not literally accurate. While the plans call for systematic or periodic investment of a specified amount, usually monthly, they do not contractually require it. Prepayments and acceleration of plan payments are not only permitted but encouraged. On the other hand, prompt monthly payments are not necessary to keep the plan in force. Failure of a planholder to make payment for 12 consecutive months usually entitles the sponsor or custodian to terminate the plan after 30 days' notice to the purchaser, but it has not been the general practice of the industry to exercise this option.

When a planholder redeems his shares before making all contemplated payments, fails to make payments on schedule, or stops making payments altogether prior to the plan's completion (or if a plan should be terminated by the sponsor because of the purchaser's delinquency) the planholder suffers no "penalty" in the sense of a forfeiture. He continues to receive dividends and capital distributions on shares already paid for. The penalty which the planholder incurs is in his paying a larger sales charge on the shares he has purchased than he would have had he purchased them outright and paid a regular sales charge, and in having had substantially less than he paid invested on his behalf. Stated another way, the "penalty" of the front-end load is that the plan purchaser may pay a selling charge on a larger investment than he has actually made, and he can reduce the cumulative average sales load to the normal load on an outright purchase only by paying practically all of the plan's installments.

The term "contractual" is particularly misleading in suggesting obligations of the purchaser. There is no contractual obligation for the purchaser to make any given number of payments. The planholder may cease making payments, and he has the right to redeem his periodic payment plan certificate for cash or the underlying shares at any time. The agreement signed by the planholder impose certain obligations upon the sponsor or plan company in exchange for its high sales load on the first 12 or 13 installments, such as the duty to sell shares to the planholder in the future with a lower sales load. However, it is not in this sense of the word that the term "contractual" is generally associated with plans in the mutual fund industry. Arthur Wiesenberger & Co. in its annual compendium of information on investment companies, states, in discussing contractual plans, that—

> The investor who terminates his plan in the early years is almost certain to have a loss—possibly a large one. This method of deducting costs had led to the use of such designations as "penalty plan," "prepaid charge plan" and "front-end-load plan." But because it formalizes the buyer's promise to himself to complete a purchase program in the shares of a specific fund in a definite way, the term "contractual plan" has become the most common.[181]

c. The voluntary plan

The contractual plan is not the only method by which an investor can embark upon a long-term program for investing in shares of a mutual fund on an installment basis. Another arrangement for the long-term accumulation of open-end investment company shares is available to anyone who wishes to make large or relatively small, reg-

[181] "Investment Companies," 1962 ed., p. 189.

ular or irregular, investments over a period of years and is commonly known as the "voluntary plan." Like the contractual plan, it also has other titles, among which are "informal plan," "accumulative plan," and "systematic investment program." Unlike the contractual plan, it involves no advance payment of sales charges; the same sales charge, usully 8.5 percent, is imposed on each payment as it is made, also giving rise to the use of the term, "level-load plan." Voluntary plans also differ from contractual plans in that the securities sold under a voluntary plan are shares or fractional shares of mutual funds themselves rather than plan certificates representing undivided interests in the underlying shares.

Although voluntary plans were not sold until 1950, their growth has been rapid. It has been estimated that as of the end of 1959 there were 500,000 voluntary plans in force (42.4 percent of all accumulation plans), as contrasted to about 680,000 contractual plans (57.6 percent of all accumulation plans). At the end of 1961, the number of voluntary plans has grown to an estimated 851,600 (47.4 percent of all accumulation plans), while 945,296 (52.6 percent) contractual plans were outstanding.

At least 200 mutual funds offer voluntary plans for the accumulation of their shares. By comparison, the underlying shares of only 63 funds are offered through contractual plans. At least 55 of the 63 may also be systematically purchased through voluntary plans which are also sold by the same dealers who retail the contractual plans.

Voluntary plans may, but do not usually, contemplate a fixed "goal" and "schedule" of proposed payments, such as $3,000 to be accumulated by payment of $25 each month for 10 years. Those which set a goal are generally the few voluntary plans offering completion life insurance. The voluntary plan purchaser makes payments as he wishes, and pays his level 8½-percent sales charge on each purchase.[182] As previously noted, approximately 30 mutual funds, representing slightly over 3 percent of the total assets of the industry, offer shares for sales at net asset value without a sales charge (no-load funds).[183] Some of these funds offer voluntary plans.

d. Contractual and voluntary plans—distinctions

(1) *The fundamental distinction*

It is evident that the fundamental substantive distinction between voluntary and contractual types of accumulative plans is the front-end load. The voluntary plan purchaser pays the same sales charge on each installment, while the contractual planholder pays a high charge on his initial installments and a lower charge on his later ones. The contractual plan purchaser thus has an economic incentive to continue payments in order to obtain the benefits of later lower charges. The voluntary plan purchaser lacks this incentive.

(2) *Other distinctions*

A number of particular features commonly associated with contractual plans are frequently cited by sponsors, plan companies or

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[182] Nearly half of the voluntary plans recite a requirement of a minimum annual purchase. However, at least one major fund group has abandoned its attempt to go through its voluntary plan accounts to ascertain whether minimum annual purchases have been made.

[183] See pt. A.1, above.

broker-dealers as advantages of investing in contractual plans.[184] Most of these features could be made available in connection with voluntary plans, and in some cases, though less frequently, they are. The distinguishing features usually referred to in this respect are completion insurance, custodianship, the right to redeem some shares and subsequently reinvest a similar amount without additional sales charge, the right to reinvest dividends and capital gains at net asset value, and the small initial payments and subsequent payments required.

(a) *Completion insurance.*—Completion insurance is available with most (58 of 63) contractual plans at the purchaser's option. Only 10 voluntary plans of over 200 make completion insurance available. Completion insurance is group term life insurance on the life of the planholder in a face amount equal to the aggregate of the unpaid installments called for under the plan. As the total amount remaining to be paid on the plan decreases, the amount of insurance and the premium (usually ranging from 50 cents to 75 cents per thousand dollars) proportionately decrease. The premium is deducted from the monthly payments. Therefore, as the amount of monthly payment for insurance premiums decreases, the portion of the monthly payment available for investment increases. If a planholder defaults in his insurance premiums by falling more than 1 month behind in scheduled plan payments, the insurance automatically terminates, but the plan otherwise continues in effect, and within 1 year of default the planholder may have the insurance reinstated upon satisfactory proof of insurability. If a planholder dies, the insurance company pays to the custodian an amount equal to the balance of the payments called for under the plan. These proceeds are then used to purchase additional shares and to pay the appropriate sales load on these shares, and a fully paid plan certificate becomes the property of the planholder's estate or of his designated beneficiary. Completion insurance thus insures that the planholder, in the event of death, will reach his goal of investing a specific amount in mutual fund shares, and that the salesman, dealer, and principal underwriter will receive the full sales charge on that amount.

Typically a purchaser of a contractual plan may prepay one or more installments and insurance premiums will be set aside from each installment against future monthly premiums. At least one fund group, selling both voluntary and contractual plans, makes no similar provision under voluntary plans with insurance, so that a voluntary planholder who accelerates his scheduled monthly payments is treated as paying merely one premium and his insurance is terminated if he fails to make a payment for the following month.

It should be noted that there is nothing inherent in contractual plans that makes them more suitable than voluntary plans for sale of completion insurance. The purchaser of a contracual plan sets a fixed investment goal in dollars, but the voluntary plan purchaser may also

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[184] The study did not consider the purported tax advantages claimed by certain contractual plans which elect for Federal income tax purposes to treat the plan sponsor, the custodian and all planholders as an association taxable as a corporation, known as a "custodianship," and to deduct from the aggregate investment income of the custodianship custodian fees and a portion of the creation and sales charges of the plan in order that, to the extent that investment income is offset by deductions, distributions to planholders may be considered a tax-free return of investment and applied to reduce the tax basis of the planholder. The validity of such deductions is presently being disputed by the Internal Revenue Service in a case before the U.S. Tax Court.

fix such a goal when he wishes, and obviously does so when he purchases completion insurance from any of the 10 funds which, as noted, do offer completion insurance with their voluntary plans.[185] The purpose of completion insurance is obviously not only to protect against the financial loss that might occur as a result of the penalty of the front-end load in the event of early death, since that penalty is a very small percentage of the potential insurance proceeds,[186] but to provide planholders with the added benefit of group (declining balance) term life insurance.

(b) *The custodian.*—The contractual planholder, as previously noted, purchases and receives a periodic payment plan certificate, while the underlying shares of the mutual fund in which his certificate represents an undivided interest are held by a trustee or custodian bank until completion or redemption of the plan, as required by the Investment Company Act.[187] Although voluntary plans are not required by law to use a custodian, in most voluntary plans a bank does have custody of the mutual fund shares purchased.[188] A certificate representing the underlying fund shares will not be issued to the contractual plan purchaser until his investment program is completed. At this point, he has the option of receiving (*a*) the underlying fund shares, (*b*) a paid-up certificate showing his undivided interest in the underlying fund shares, or (*c*) cash in the amount of the net asset value of the shares.

However, at any time, upon the investor's request, the investment company (in the case of voluntary plans) or plan (in the case of contractual plans) will purchase from the custodian at net asset value all or any part of the shares credited to the investor's account, or, on the planholder's election to terminate his investment program, the custodian will deliver to him a certificate representing all of the whole shares in his account.[189]

Despite some general similarity in custodial operations in contractual and voluntary plans, there are two significant difference in the results of custodianship under the two types of plans.

(i) *Notices.*—Since on most voluntary plans there is no scheduled goal or monthly payment schedule, the custodian for a voluntary plan usually sends out no notice of payments to be made other than a form and envelope for use when making the next payment, which accompanies each receipt of payment. In contrast, the sponsor of a

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[185] The goal without the penalty appears to have produced a very high proportion of systematic payments on at least one voluntary plan with completion insurance. See sec. 7.h(2), below.

[186] The maximum penalty that can be sustained by a contractual planholder is the difference between the maximum front-end load he can pay—50 percent of his first 13 payments—and the reduced cumulative average load of about 8½ percent that he pays if all proposed payments are completed. For example, on a $25-per-month, 10-year plan, the 50-percent load on the first 13 payments ($325) is $162.50. If the planholder completes all payments under the plan ($3,000) the average sales load on these 13 payments is "reduced" to 8½ percent or $27.63. Thus, the maximum penalty on the plan is $162.50 minus $27.63, or $134.87. Yet the proceeds from a term life insurance policy at payment 13 on a $25-per-month, 10-year plan amount to $2,675 ($3,000 minus $325).

[187] Secs. 27(c)(2) and 26(a)(2).

[188] Voluntary plan purchasers buy mutual fund shares directly, unlike contractual plan purchasers who buy a periodic payment plan certificate evidencing an interest in the shares, but the shares purchased are not generally issued in their names or delivered until termination of the plan. Instead the custodian establishes an account showing ownership of full and fractional shares, as it does for contractuals, since this involves considerably less expense than issuing share certificates for full and fractional shares after each payment. A receipt is sent to the investor after each payment, together with a form and envelope for use in making the next payment. A few voluntary plans upon request will send the investment company share certificates to the purchaser at the time of such payment, but for most plans certificates will not usually be issued until the account is terminated.

[189] Fractional shares are then repurchased by the investment company or plan at the prevailing net asset value.

contractual plan—where there is a monthly payment schedule—arranges with the custodian bank to continue to forward a monthly reminder to planholders. It is customary to follow up "reminders" with one or more "delinquency" notices. If 12 or 18 months elapse in which no payment is received, some custodians send the planholder a notice that the sponsor may terminate the plan if a payment is not made within 30 days.

Differing notice arrangements are not, however, inherent in the differences between voluntary and contractual plans. For voluntary plans sold with insurance, a warning that the insurance may lapse is generally sent to the planholder when his payment is not received on time, and at least one sponsor mails monthly reminders to voluntary plan purchasers who wish to receive them, at no extra cost to the purchaser.

(ii) *Custodians' fees.*—A related distinction between custodianship on voluntary and contractual plans is the manner of paying the custodian for its services. In most contractual plans a custodian's fee, in addition to the sales load, is deducted from each planholder payment. Except for the few voluntary plans sold with completion insurance, the custodian's fee under voluntary plans is not paid by the investor but is generally allocated among the principal underwriter, the dealer, and the investment company.

On most contractual plans calling for payments of less than $50 per month, the custodian's fee is usually 2 to 3 percent of each payment. On contractual plans calling for payments of $50 to $150 per month, the fee may range from 1½ to 2 percent of each payment, while on plans providing for payments of $150 per month or more, the fee may often be 1 percent or less. When added to the usual 8.5-percent sales charge, the normal custodian's fee of 2 percent brings to 10.5 percent the total of sales load and fees that are deducted from a plan if completed.[190] The 2-percent deduction for the custodian's fee, when added to the 50 percent deducted from each of the front-end-load payments, means that less than one-half of each of the first 12 or 13 payments is invested for the benefit of the planholder.

Less commonly, the contractual plan custodian's fee is deducted at the end of the year from dividends [191] accruing to the planholder on the basis of a fixed amount for each share held, which amount is frequently smaller than under the more usual method. Some contractual plans provide that when no payments are made for 1 year or over, the custodian may deduct from dividends or, if these are insufficient, from capital, an annual fee—for example, 0.2 percent of the total agreed payment called for by the plan, limited to a maximum of $24 a year. For contractual planholders who stop making payments after only a few installments, this arrangement may result in having not only their dividends but some of their capital investment consumed by the custodian fee.[192]

[190] This figure does not take into consideration an annual service charge, usually not to exceed $1.50, provided for by many contractual plans, which is payable after 1 year's payments or their equivalent has been made. This charge is payable out of income or capital distributions and to the extent necessary from the sale of fund shares.

[191] If dividends are insufficient deductions are made from capital.

[192] A 0.2 percent annual fee on a $3,000 ($25 monthly, 10-year) contractual plan would amount to $6. Since accounts that paid only six installments would have about $70 invested, capital would be reduced unless the $70 investment produced income of $6 per year after payment of the management fee.

(c) *Withdrawal and reinvestment (without sales charges).*—Contractual plans, but not voluntary plans, usually permit a planholder who has made a specified minimum number of payments to redeem up to 90 percent of the number of underlying shares without terminating the plan, with a right subsequently to repurchase the same number of shares substantially at their net asset value at the time of repurchase. (A service charge, such as $2.50, is incurred for each such transaction.) This privilege is intended to afford contractual plan purchasers an opportunity to use their investment to meet emergencies without being subjected to a second sales load when they repurchase shares they have withdrawn. The 90-percent redemption privilege does not, however, reduce the penalty of the front-end load at the time of withdrawal. The purchaser who withdraws shares has paid an average sales load in excess of the normal 8.5-percent charge on the shares withdrawn, and only by repurchasing the number of shares withdrawn and completing his plan can he bring the overall sales charge down to 8.5 percent.

(d) *Investment of dividends and reinvestment of capital gains at net asset value.*—Both contractual and voluntary plans make provision for the automatic investment of dividends and reinvestment of capital gains distributions, as do "single-payment" programs, and some funds have similar provisions for nonplan, lump-sum purchases. The principal differences relate to whether such investments will be made at net asset value, or at net asset value plus a sales load. All contractual plans are required [193] to offer, and many voluntary plans by choice offer, dividend and capital gains reinvestment at net asset value; i.e., without deduction of sales load. In other voluntary plans and nonplan situations a sales load is deducted upon reinvestment of dividends.

(e) *Minimum initial and subsequent payments.*—With one exception, contractual plans of all sponsors may be initiated with a minimum payment of from $20 to $60, with the minimum size of subsequent monthly payments ranging from $10 to $25.[194] Most sponsors require a double initial payment on all or nearly all initiations of contractual plans. A few require a first payment of three installments and one requires initial payment of five installments.

Voluntary plans, on the other hand, usually require a more substantial initial payment. Of over 200 mutual funds which can be bought through voluntary plans, about 77 percent require an initial payment of from $100 to $500. However, the rest may be started with an initial payment of $50 or less, and the subsequent minimum payment requirements range up to $50.

At least 55 funds' shares can be purchased under both contractual and voluntary plans, and of these there are only 13 in which voluntary plans can be initiated with a payment of less than $100. Another 17 require a minimum initial payment of $100, $150 or $200 on voluntary plans, and 3 of these require subsequent payments in amounts of $50 or more. The remaining 25 funds call for an initial voluntary plan payment of $250 or more, and all 25 require subsequent payments of no less than $50.

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[193] The Commission determined in 1949 that deduction of sales load upon reinvestment of capital gains or dividends on a periodic payment plan certificate would violate sec. 27(a) of the Investment Company Act and that the payment by the custodian of such deduction would violate sec. 26(a)(2) of the act.

[194] Sec. 27(a)(4) of the Investment Company Act prohibits the sale of any contractual plan with a first payment of less than $20 or any subsequent payment of less than $10. Thus, $10- and $15-per-month plans provide for double initial payments of $20 and $30, respectively.

Nevertheless, voluntary plans which require only small initial or subsequent payments are available to persons seeking a systematic investment program with small initial and continuous payments, and the purchase of a contractual plan is not the only method by which such a systematic program can be instituted.

(f) *Sales load reductions.*—Volume discounts on sales charges are not generally permitted to purchasers of voluntary plans because under the law [195] this would be deemed to discriminate against nonplan purchasers of shares of the same investment company.[196] Since the security sold by a contractual plan is a periodic payment plan certificate rather than the underlying shares of an open-end investment company, a scale of reduced sales loads is available on substantial purchases made through contractual plans, and is not considered to discriminate against persons who purchase the fund shares directly through other methods.

As a result of the discounts available under contractual plans, it can be cheaper for a purchaser to select a contractual plan instead of a voluntary plan when he contemplates a monthly payment of $250 or more, assuming that all payments are made on the contractual plan. For plans calling for payments of $200 per month and less, total fees on contractual plans—sales load plus custodian charges—are usually higher than on voluntary plans.

e. Industry justification for front-end loads

The feature of the contractual plan which essentially distinguishes it from the voluntary plan—the front-end load—has been the subject of sharply differing views. The Association of Mutual Funds Plan Sponsors, Inc. (AMFPS), a trade association organized to promote the common interests of firms sponsoring contractual plans [197] indicates in its literature [198] that a planholder who finds it necessary to cancel his plan during its early years will suffer a loss. This risk is justified by industry spokesmen, principal among them the AMFPS, on several grounds.

The general justification is stated in terms of the desirability of encouraging persons of modest means to invest in mutual funds. According to the AMFPS:

> The mutual fund principle * * * makes available to people of modest means investment facilities hitherto considered exclusively within the province of the wealthy. Through a mutual fund the shareholder is able to pool his funds, no matter how large or small, with those of other investors. This enables him to enjoy the benefits of diversification of risk, and employment of professional advisers to select and supervise his securities.[199]

The AMFPS goes on to say that the sales policy of the plan sponsors may—

> eventually encourage * * * millions of policyholders, government bondholders, and savings owners to supplement their insurance and holdings of savings bonds with an investment in securities, thus bringing Main Street to Wall Street.[200]

[195] Sec. 22(d), Investment Company Act.

[196] Under a "Letter of Intention," however, lower charges are often available on quantity purchases to voluntary plan purchasers who, within 13 months, invest amounts of $10,000 and over.

[197] As of Dec. 31, 1962, 22 of 50 principal broker-dealer organizations known to be contractual plan sponsors were members of the AMFPS, and represented over two-thirds of aggregate payments under all sponsors' outstanding contracts.

[198] "The Origin and History of the Contractual Plan" (herein cited as "Origin and History"), published by the AMFPS, revised in 1960 and supplemented in 1961, 1962, and 1963, is the source of all statements and statistics attributed to the AMFPS in this report, unless otherwise specified.

[199] Origin and History, pp. 2–3.

[200] Id., pp. 22–23.

The Commission does not generally and the study does not now take any position concerning the desirability or undesirability of encouraging equity investments on the part of persons of modest means, or of any means. It is appropriate to note, however, that the general industry position outlined above applies to contractual and voluntary plans alike, and to mutual funds generally, apart from the front-end-load feature of the contractual plans. In support of the front-end-load feature itself, spokesmen for the industry generally advance three arguments: (1) a great majority of contractual plan purchasers have realized profits, while the number of those who have lost money and the amounts lost are small; (2) the stimulus of a goal and a penalty is necessary for most persons in order to induce them to invest and save regularly, supported by the assertion that " 'contractuals' * * * achieve a much lower rate of cancellation";[201] and (3) the front-end load is necessary to compensate salesmen and sponsors adequately for the time and other expenses involved in educating the public in the value of purchasing mutual funds on a periodic basis, following up delinquent accounts, and fostering habits of systematic saving. Each of these arguments is briefly discussed here.

(1) *Profits of plan purchasers*

Sponsors place great emphasis on the point that over the years a relatively small percentage of contractual plan accounts have been terminated with a loss, and that most contractual planholders have, or as of any specified dates could have, redeemed their accounts with a gain. The argument was stated in the following manner in a publication of several years ago submitted by the AMFPS to the Special Study:

> The period 1949 through 1954 was one of generally rising securities prices, with pronounced breaks however in mid-1949 and mid-1950, and with generally declining prices during the first 9 months of 1953. We of course concede that this generally rising market improved the end results reflected on the past record, but we submit that a generally rising market is not essential to good end results reflected under a periodic investment plan. We contend that dollar cost averaging, the generous yield usually received from common stocks, the long-term appreciation in value that can reasonably be expected from common stocks, and the compounding of shares, will give good end results in any kind of a securities market we have ever had, granting only *time*, and we insist that the quite modest loss sustained by those planholders who abandoned their plans in the early stages, and the very favorable end results obtained by the other planholders, was and is due as much to the factors of generous yield, appreciation, and compounding, as to the favorable market action in the period in question.[202] [Emphasis in original.]

Yield, appreciation, and compounding are also available, however, in mutual fund shares purchased through voluntary plans which offer reinvestment of dividends at net asset value. As between contractual planholders and voluntary planholders, it is clear that these characteristics will be of greater benefit to the latter, who will have 91.5 percent rather than 50 percent of their first 12 or 13 payments in their accounts, regardless of long- or short-term market trends. The advantage of applying yield, appreciation, and compounding to a larger initial investment out of an equal initial payment would appear to lie behind

[201] Id., p. 14.
[202] "A Review of United's Periodic Investment Plan" (1959), p. 35.

the recently quoted concession of an executive of a contractual plan sponsor:

In a long-term rising market, the contractual usually won't turn out as well as a voluntary purchase plan.

The industry argument relating to the relatively small percentage of contractual plan accounts terminated with a loss is consistently made, as suggested above, in the context of a long-term market. It should be borne in mind that industry experience figures in this respect reflect the generally consistently rising markets of the last 15 years, and undoubtedly show smaller losses than would have been experienced in a level or declining market.

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. Because of the heavy front-end load of a contractual plan, coupled with the custodial fee, the contractual planholder, as noted, has substantially fewer dollars working for him during the first year than under a voluntary, level-load plan. As a result, the contractual plan, notwithstanding the sharp reduction in sales load after the first year, will, except under rare circumstances, be unable to accumulate as many shares of the mutual fund during the life of the plan—assuming it is carried to completion—as will the voluntary plan. The advantage of the voluntary plan is accentuated during a period of rising common stock prices.

To demonstrate the varying effects on a planholder's investment of a front-end-load plan of accumulation versus a level-load plan, the study obtained figures comparing for the most recent calendar 10-year period (January 1, 1953, to December 31, 1962, a period of generally rising common stock prices), at yearends, the accumulated values of shares of a well-known balanced fund acquired under contractual and voluntary plans. The following table sets forth such data, based on the following assumptions: (1) monthly payments amount 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 with the sales load on the contractual plan, however, amounting to 44 percent of each of the first 12 installments and 4 percent of each of the remaining 108 installments; (3) an annual custodial fee of 1.5 percent of payments is deducted under the contractual plan; and (4) income dividends are reinvested and capital gains distributions are accepted in additional shares at net asset value, with no adjustment being made, under either type of plan, for any income taxes payable by shareholders on such dividends and distributions.

TABLE XI-d.—*Comparison of yearend values of voluntary and contractual plans in a balanced fund*

Dec. 31—	Voluntary plan (1)	Contractual plan (2)	Amount of difference (3)	Percent difference [1] (4)
1953	$1,143	$608	$535	88.0
1954	2,786	2,124	662	31.2
1955	4,411	3,686	725	19.7
1956	5,725	5,006	719	14.4
1957	6,537	5,887	650	11.0
1958	9,679	8,887	792	8.9
1959	11,686	10,862	824	7.6
1960	13,465	12,636	829	6.6
1961	17,199	16,257	942	5.8
1962	17,439	16,588	851	5.1

[1] Computed by dividing col. (3) by col. (2).

As noted in the foregoing table, assuming the plans are carried to completion, there are marked differences in the accumulated values under the two types of plans. Thus, at the end of the 1st year, the value of the shares held under the voluntary plan exceeds that under the contractual plan by 88 percent; at the end of the 5th year, the margin of difference in favor of the voluntary plan is 11 percent; and at the end of the 10th year, where all scheduled payments have been made, the margin of difference, also in favor of the voluntary plan, is 5.1 percent.

(2) *Systematic saving and the stimulus of a penalty*

From the point of view of the individual investor, the contractual plan industry takes the position, which is emphasized in much of its selling literature, that the front-end load provides a valuable incentive to invest. As one witness testified, "We stress in our training that most people need a penalty to accumulate any money over a long period of time, and we use this as a sales point, sir, not as a deterrent." The AMFPS puts the argument this way:

> The reason that causes the "contractuals" to achieve a much lower rate of cancellation is the sense of obligation that they impose on the planholder to set aside his required monthly payments. He is made aware of the fact that he may lose a substantial part of the payments previously made under his plan in the event of early cancellation, and thus periodic payments become habitual with him.[203]

The validity of this argument rests on the assumption that contractual plan purchasers have a substantially better performance record as investors than voluntary plan purchasers. The limited statistical data underlying this assumption are discussed below, and the limits of the conclusions which can be drawn from it are noted.[204] It is clear, however, 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. The Mutual Fund Investor Survey shows that 82 percent of the contractual plan purchasers covered by the survey reported that salesmen had called their attention to the discipline which plans impose on savings habits, and 45 percent reported that

[203] Origin and History, p. 14.
[204] See sec. 7.h, below.

they had chosen this mode of investment for that reason.[205] Among contractual plan redeemers covered by the survey, a majority of whom reported losses on their investments, those who nevertheless felt that benefits had been provided placed major emphasis on the encouragement of discipline in savings.[206] The extent to which the plans actually are successful in creating regular savings habits is discussed below.[207]

There may be some question concerning the role which the front-end load plays in stimulating regularity in investment as compared with other contributing factors such as periodic reminders and completion insurance. The study's observation of marked superiority of systematic payment records and lower rates of redemption and "lapse" of contractual plan accounts initiated with completion insurance[208] (as opposed to plans sold without such insurance) suggests that maintenance of completion insurance may often be a more important stimulant than the penalty of a front-end load. Also, the Mutual Fund Investor Survey notes:

On the issue of whether, having begun the contractual periodic investment plan, there was any disadvantage if the plan were not carried out, 60 percent indicated that there was a disadvantage, but, significantly, 32 percent said that there was not, and an additional 8 percent did not know.[209]

For the 40 percent who were unaware of the penalty imposed by the front-end load, it cannot be said to serve as a stimulant to savings.

(3) *Necessary incentive to salesmen to encourage small investors*

The contractual plan industry also justifies the front-end load on the grounds that it is the only way in which funds can be sold to the small investor, with $25 or $50 a month to invest, and that a good salesman is worthy of his hire. The contractual plan, one industry witness testified, "is the only way that the small monthly plan investor can be approached, can be put into this type of a program." Otherwise, "a salesman cannot economically or profitably * * * go out and make a living selling this type of investor." The Mutual Fund Investor Survey has noted that purchasers of contractual plans spent approximately twice as much time with their salesmen as with purchasers of shares through regular accounts.[210]

The AMFPS has said of the front-end load:

Without the sponsor being able to deduct the greater part of his overall fees from the first year's payments, it would be impossible to offer responsible sales personnel adequate compensation and incentive. Nor would the sponsor be able to absorb the cost of periodically following up delinquent accounts. * * *[211]

James M. Landis, chairman of the AMFPS, has stated the argument in greater detail:

The elimination of the front-end load, however, appears impracticable. Competent salesmen, especialy those who have such intricate merchandise to sell, must be adequately rewarded or else less qualified individuals will be available to assume such important responsibilities. The sale of life insurance has the same problem and meets it essentially in the same way. Moreover, the person of

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[205] App. A, sec. IV.b.1.
[206] Id., sec. XIV.
[207] See sec. 7.g(1), above.
[208] Ibid.; and tables XI–5 and XI–6.
[209] App. A, sec. X.E.
[210] Id., sec. V.E.
[211] Origin and History, p. 15.

average means is generally negligent to a degree in the matter of estate planning and systematic saving. To some extent he must be "forced" to save and "forced" to initiate and maintain payments on his life insurance. The lack of progress of so-called voluntary plans and of savings bank life insurance as contrasted with the progress of essentially the same wares in combination with active personal merchandising is evidence that "planning" requires selling, and selling is an occupation that requires rewards.[212]

The manner in which the compensation systems for contractual plan salesmen offers incentives to salesmen and sponsors to encourage systematic saving in the early stages of a plan is illustrated in "The Origin and History of the Contractual Plan":

In some cases, the commission on a voluntary plan may run slightly lower than on a contractual plan, but assuming a $6,000 investment in each type plan at the rate of $50 monthly, the commission on the "voluntary" where the load on the underlying shares is 8 percent, will aggregate $480 which will be deducted at the rate of $4 from each $50 payment. The service fees on the "contractual" with an overall sales charge of 8 percent will also aggregate $480, except that $22 will be deducted from each $50 payment 1 to 12 inclusive ($264), and thereafter will be deducted at the rate of $2 from each $50 payment beginning with the 13th and ending with the 120th payment ($216).

If in the case of the "voluntary," the dealer receives 6 percent of the 8 percent markup (or $3 of the $4 charged against each payment) and splits 50–50 with the salesmen, the $1.50 each receives provides no incentive for them to devote time and effort in following up the investor who permits his account, through failure to make payments, to become inactive. However in the case of the "contractual," where the salesman's commission may run approximately eight times greater on the same size payment (viz, $12, or more, on each $50 payment—1 to 12 inclusive), the incentive is there for both salesman and sponsor to materially assist the investor to form the habit, during the early years of the plan, of [systematic investing]. * * *

While the example illustrates the salesman's incentive to encourage his customer to develop systematic savings habits until the first 12 or 13 payments are made, it also demonstrates that the incentive is substantially decreased after the front-end load payments are made, since the salesman's commission on each subsequent payment amounts to less than $1 on a $50-per-month plan—about one-twelfth of what he receives on one of the first 12 payments. Industry representatives concede that if the contractual salesman does not develop the habit of systematic investing in his customer by the time he has made the first 12 payments, the salesman is unlikely subsequently to spend much time following him up.

Statistics obtained by the Special Study in a manner described below indicate that the percent of accounts which were redeemed or "lapsed" [213] prior to the payment of the first 12 or 13 installments was higher for accounts in the $10-to-$40-per-month range than for accounts in the range of $50 per month and over. Other influences may help account for this difference, but to the extent that salesmen's followup is a factor it would appear that in plans of $25 per month or less, the front-end load may provide a sufficient incentive for a salesman to sell a plan but an insufficient incentive to cause him to follow up on early delinquent payments.

The front-end sales load also encourages a salesman to obtain prepayments on contractual plans, since prepayments accelerate the payment of his commission, and to the extent that prepayments are made the salesman's inducement to encourage subsequent systematic invest-

[212] Origin and History, p. 25.
[213] Had made no payment for a 12-month period.

ment by the customer is decreased. For example, if the customer has initiated a plan with four more installments than necessary and later becomes delinquent in his payments, there are four fewer times when the salesman has an inducement to call upon his customer. To the extent that the continuing service of salesmen is relied on as a justification for the front-end load, therefore, the payment of the full sales commission out of prepayments is inconsistent with this objective.

The front-end load is undoubtedly valuable in recruiting salesmen to sell contractual plans, but the impracticability of its elimination is not entirely clear. In those States where the sale of contractual plans is prohibited there appear to be salesmen available to sell voluntary plans. According to the Commissioner of Corporations of California, the largest of the States which prohibits the sale of contractual plans:

> It is the impression of my staff that the elimination of front-end loads and contractual plans in California has not substantially reduced the sale of mutual fund shares in California. It is their impression that the elimination of front-end loads has compelled mutual fund companies to concentrate in California on other sales methods.

California led all other States in mutual fund sales in 1962, with per capita sales of $34.18 against per capita sales of $22.83 for New York, the next largest State, and a national per capita average of $14.19.

f. Criticisms of contractual plans

The arguments of the critics of contractual plans generally relate to the "fairness" of the penalty provision or to the effect of the front-end load in "locking" a purchaser into a particular investment, or a combination of the two. Thus the Securities Commission of Illinois, a State which sharply limits the sale of contractual plans, concludes:

> From inquiries and complaints received in this office, it has been our experience that many times contractual plans are established in income brackets wherein the possibility of discontinuance is great and where the holder can ill afford such a heavy surcharge * * *. We feel that such plans, locking in the purchaser and penalizing the purchaser if he finds it necessary to "unlock" himself are grossly unfair to the public.

Similarly, the Director of the Department of Securities of the State of Wisconsin, which has a statutory provision requiring that methods used in the sale of securities not be "* * * unfair, inequitable * * * as to purchasers, or against public interest or the interest of investors," states:

> Pursuant to these statutory provisions and our rules, this department has always taken the position that the high commissions involved in front-end load transactions are contrary to public policy and against the public interest and the interest of investors.

The manner in which the front-end load imposes a financial burden of "penalty" on the plan purchaser who does not complete his scheduled payments has already been discussed. In addition, the front-end load penalty "locks in" purchasers who find themselves in unanticipated adverse circumstances, and may induce a planholder to persist in monthly payments when he might more wisely use the money elsewhere. The Commissioner of Corporations of California has written:

> An investment program, although important, is not the only thing in life. On August 16, 1962, can I determine whether on July 16, 1963, I ought to invest $300 in a mutual fund, or not? Can I not better make that choice then? Suppose

(contrary to any present ideas) I would then be married to a woman with six small children and the $300 was clearly needed for shoes, milk, and the rest. Would it not be better for me that I could then discontinue the investment program without penalty?

The suggestion of this critic that changed circumstances may result in premature redemption of contractual plans is supported by that part of Mutual Fund Investor Survey which relates to redeemed accounts.[214] The survey ranked the purpose for which funds were redeemed from the most to the least pressing needs to obtain cash, with payment of medical or hospital bills, payments of other types of debts, or household or personal expenditures as the most urgent purposes. In terms of this ranking, it found that the use by contractual planholders of mutual fund shares as a source of "rainy day" savings was clearly evident. Sixty percent of those redeeming contractual plans reported they had used the proceeds for household or other personal-expenditure purposes, including medical bills and the repayment of other debts. In contrast, these purposes for redeeming were listed only by 25 percent of regular account holders. About 33 percent of those redeeming contractual plans suggested that they had acquired information after their purchase which would have had significance in their original decision, principally stressing topics relating to sales charges—such as learning of the front-end load after their purchase and learning of methods of acquiring mutual funds without a front-end load. Some of those redeeming did not appear to understand the impact of the front-end load, but of those who recognized the impact of front-end loads on effective sales charges at redemption, over 25 percent reported that they did not, at the time of purchase, anticipate this effect if their plans were not completed. The responses of redeeming planholders also reconfirmed evidence from the Mutual Fund Investor Survey that a considerable number of purchasers apparently acquired contractual plans when they had little or no financial reserves.

The 90-percent redemption privilege[215] does afford contractual plan purchasers an opportunity to use their investment to meet emergencies without again being subjected to another sales load if they repurchase part or all of the withdrawn shares. This provision can be helpful to a planholder who is required by an emergency to use some of his contractual plan savings and who wishes and can afford to resume his contractual plan payments at a later time. However, as noted, the provision does not reduce the penalty of the front-end load at the time of withdrawal, and in cases where repurchase does not occur offers no advantage at all.

In evaluating the fact that a planholder is locked into his investment by the front-end load, it should be noted that this situation inhibits changes of investments by a planholder who determines, some time after starting a contractual plan, either that the underlying fund's management has deteriorated or that his investment objectives have changed. Only by subjecting himself to a heavy penalty can such a contractual plan purchaser change either his existing or future investment to another mutual fund or another investment medium.

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[214] App. A, secs. XII, XIII, and XIV.
[215] See subsec. d(2)(c), above.

g. Performance record of contractual plan investors

Much of the debate over the merits of the contractual plan has been carried on in the absence of any substantial body of statistical data concerning the performance record of contractual plan purchasers. The AMFPS's "Origin and History of the Contractual Plan," and its 1961 and 1962 supplements, contained some information, and further data were submitted to the Special Study by Waddell & Reed, Inc. (W. & R.), a large contractual plan sponsor. The AMFPS and W. & R. statistics are discussed below. However, in view of the limited nature of the available statistical data, the Special Study itself undertook to collect and analyze data on the performance record of a sample of contractual planholders.[216]

(1) *Special Study statistics on performance*

Any evaluation of the contractual plan method of selling mutual funds must ask two basic questions: (1) how successful have the stimulus of the "penalty" and the efforts of the selling organizations been in promoting habits of systematic investing among those who joined these plans, and (2) how much have participants in fact paid for sell-charges under contractual plans? To provide a factual basis for answers to these two questions, the Special Study obtained payments records for a systematic sample of 1 out of every 10 accounts opened in February 1959 on every outstanding contractual plan on which aggregate agreed payments totaled at least $75 million at the end of 1959. The nine plans in this category represented 82 percent of outstanding aggregate agreed payments in the entire contractual plan industry at that time. February 1959 was selected as a typical month, recent enough to reflect current selling practices, yet sufficiently distant in time to show several years of payment, lapse, and redemption performance.

Data collected from the plan sponsors on form IC-8 (shown in app. C), covered a total of 1,451 accounts. Of these, however, 14 accounts were completed in the first month, serving their purchasers as a form of lump-sum purchase (rather than as a periodic payment plan) evidently for the advantage of reduced overall load contained in some contractual plans. These 14 accounts were accordingly excluded from the sample, leaving 1,437 accounts as the basis for study.

For the purpose of analysis, the 1,437 accounts have been divided into "completed," "inactive," and "active" categories. Accounts are classified as completed upon payment of the full number of installments contemplated for the entire plan; for example, 100 or 150, whether such payment is made by the planholder or by the proceeds of completion insurance upon his demise. In the "inactive" category are *redeemed* accounts—uncompleted accounts no longer making payments which have been redeemed for cash or share certificates[217]—and *lapsed* accounts; that is, uncompleted, unredeemed accounts on which no payment has been made for 12 or more consecutive months. This definition of "lapse" conforms to that used in AMFPS statistics. Accounts are classified as "active" if they are neither completed, redeemed, nor lapsed—whether they have been active throughout the period since the accounts were opened (never completed, redeemed,

[216] Throughout the discussion which follows, the terms "planholders" and "accounts" are used interchangeably.

[217] Accounts redeemed for cash or share certificates subsequent to completion are not classified as "redeemed" in this analysis.

or lapsed) or *reactivated* by payment of one or more installments following an earlier lapse.

Analysis of the 1,437 sample accounts on this basis showed that by August 31, 1962, 3½ years after these plans had been initiated, 36.9 percent of the original accounts were inactive, including 22.1 percent which were lapsed and 14.8 percent [218] which were redeemed. Another 4.7 percent had prematurely completed all required payments and the remaining 58.4 percent were still active (neither completed, redeemed, nor lapsed) (table XI–5).

The pace of dropouts through lapse or redemption over the intervening months between February 1959 and August 1962 should be noted. Some 6.2 percent of all accounts dropped out at the very start, making only their initial payments in February 1959 and lapsing or redeeming thereafter (table XI–6). The annual pace of dropouts through redemption, as shown by chart XI–a and table XI–4, amounted to 3.3 percent of the original accounts the first year, 3.9 percent the second, and 6 percent the third. During the next half year, ending August 1962, redemptions amounted to 1.6 percent, bringing to 14.8 percent [218a] the total of plans redeemed during the 3½-year period. The annual increase in lapsed accounts meanwhile, amounted to 6 percent of all 1,437 accounts the first year, 10.3 percent the second, 4.2 percent the third year, and 1.6 percent in the next 6 months (table XI–4). 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. Unlike redeemed accounts, moreover, not all lapsed accounts remained inactive; over the 3½-year period 4 out of every 20 lapsed accounts were reactivated, 1 of the 4 only to lapse once more.

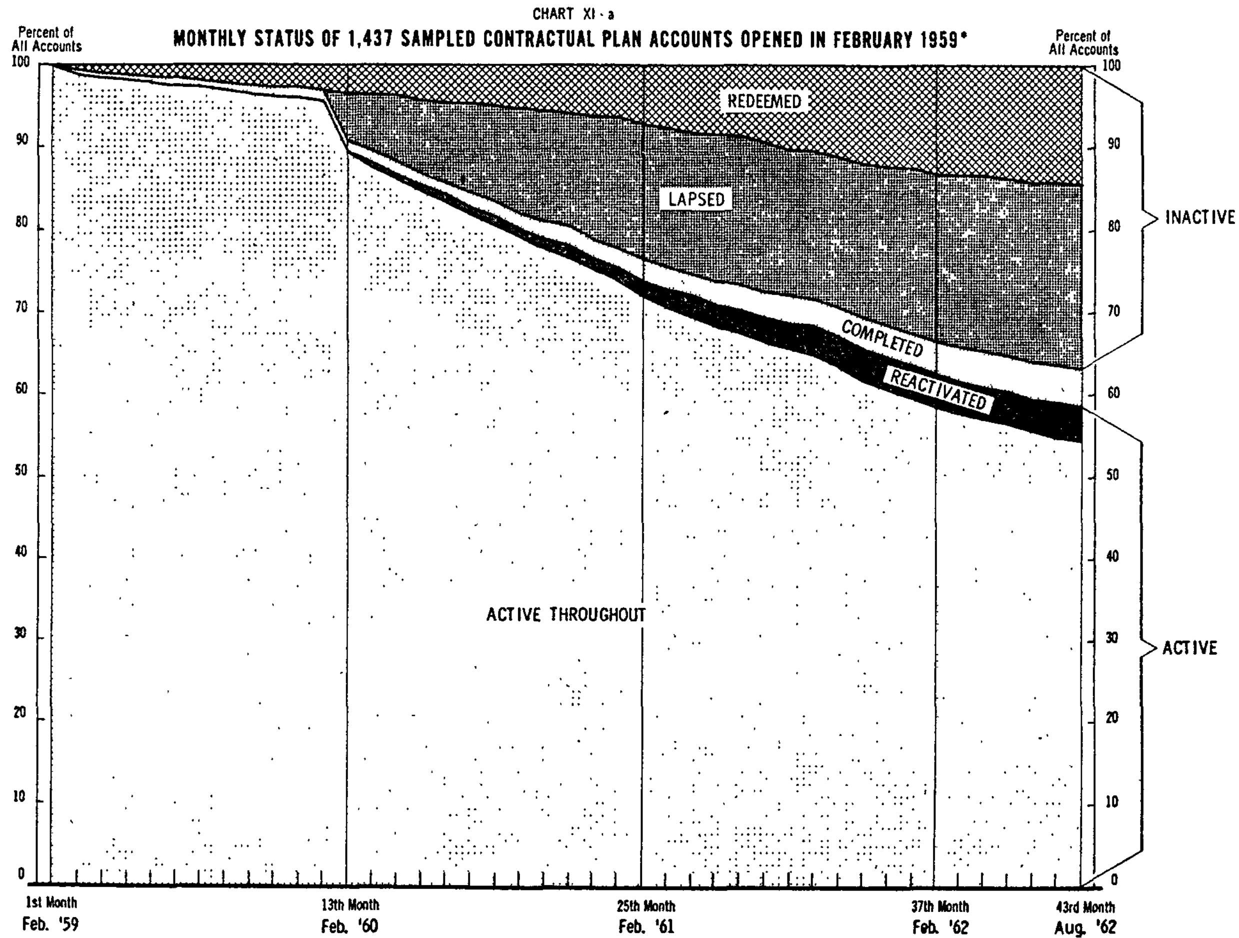
The 36.9 percent of the original accounts which were inactive through lapse or redemption clearly represent plan purchasers for whom the stimulus of the "penalty" had failed to promote habits of systematic saving. Whatever may have been the impact of the "penalty" on the 4.7 percent which had prematurely completed their plans, it appears that not all of the 58.4 percent of active accounts were held by planholders who could be described as "systematic investors." Among these planholders a wide range of performance is evident. At one extreme, approximately one-sixth of active accounts were held by planholders who missed not a single month. On the other hand, one-tenth of active accounts had made payments of single or multiple installments in one-third or less of the 42 months between the end of February 1959 and the end of August 1962.

Another perspective upon payments performance may be gained by examining the extent to which payments were systematic, from the vantage of the number of months in which all participants (active, inactive, and completed) actually made payments of either single or multiple installments. Here a wide spectrum of performance also emerges. At one extreme, one-third of all accounts made payments in at least five-sixths of the 42 months, including one-tenth of all accounts missing not a single month (table XI–6). At the other extreme, one-third of all accounts made payments in fewer than one-third of the months, including one-fifth of all accounts making payments in fewer than one-sixth of the months. Of the remaining one-third of accounts, some 24 percent of all accounts made payments in from one-half to five-sixths of the months, while 10 percent paid in

[218] Includes 1.3 percent of accounts redeemed with sales charge returned.
[218a] Ibid.

CHART XI-a

MONTHLY STATUS OF 1,437 SAMPLED CONTRACTUAL PLAN ACCOUNTS OPENED IN FEBRUARY 1959*



*Excludes 14 accounts completing payments in February 1959. See ch. XI, B. 7.g.(1) for description of status classifications. Covers plans calling for payments over periods of from 8 to 16 2/3 years.

one-third to one-half the months. Those accounts in a median position, arrayed in the very center of the group, made payments in roughly three-fifths of the 42 months.

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.

A comparison of the payment performance of planholders in the study sample who purchased completion insurance with those who did not suggests that such insurance is a stimulant to regular investing. By August 1962, 16.3 percent of accounts initiated with completion insurance had made a payment every month, compared with 9.2 percent of the uninsured accounts; 29.3 percent of those initiated with insurance had missed payments in 21 or more months of the 42-month period, while 48.1 percent of uninsured accounts were in this category (table XI–6). There was, however, a tendency for uninsured planholders to make more payments of multiple installments than did insured planholders. Redemptions without return of the sales charge amounted to 12.1 percent of the plans initiated with completion insurance and 13.9 percent of uninsured accounts (table XI–5). The difference in lapses is more marked, with 12.1 percent of insured accounts lapsed on August 31, 1962, compared with 25.1 percent of uninsured accounts.

To determine whether the 30-day refund privilege offered to plan purchasers by sponsors who are members of the AMFPS had an important relation to the redemption and lapse patterns noted by the Special Study, the payment records of purchasers from sponsors offering the refund were compared with those of purchasers from sponsors not offering the refund. The results appeared inconclusive. While purchasers offered the refund privilege had a somewhat lower rate of redemptions, their lapse rate was higher than that of the other shareholders.

In examining the second question—the sales charge actually paid by those purchasing contractual plans—it must be borne in mind that the average sales load paid by contractual plan participants is not a function of time; it is a function of the *number* of installments paid. A nonsystematic planholder paying multiple installments would reduce the average sales load as effectively as a planholder who paid an equal number of installments systematically. By paying a greater number of installments, a nonsystematic planholder will attain a lower sales load than the systematic planholder paying fewer.[219] Thus, to de-

[219] This may be illustrated by an example of two persons who purchase a $50-per-month plan on the same day. Both redeem 2 years later. The first makes all 24 payments (in-

termine the effective front-end sales load "penalty" on redeemed or inactive plans, the pertinent element is the number of installments paid rather than the number of months, or years, since the plan was initiated.

Since many contractual plans provide that accounts can be opened only with payment of two or more installments[220] and prepayments are generally encouraged, a considerable number of accounts paid more than one installment on initiation of their plans. Only 13 percent of the purchasers initiated their plans with a single installment, 42 percent paid two installments, while 18 percent paid three to five installments, and 27 percent six installments or more (table XI–7). While the median initial payment thus was of two installments, the average was 5.9 installments (table XI–8). The predominance of multiple payments was not maintained thereafter, however, for in the rest of the 43-month period the average number of installments per payment was 1.5. As has been previously noted, however, only one-tenth of all accounts made a payment in each of the 43 months. Thus, neither the number of months elapsed nor the number of months in which payments were made can accurately reflect total payments and the effective sales load.

Accordingly, to gage accurately the effective load upon contractual plan participants, the total number of installments paid by each account was examined. The results, presented in tables XI–e and XI–9, reveal that 1 out of every 6 planholders (16.8 percent) had paid an effective load of 50 percent.[221] Virtually all (16.2 percent) of these plans had been redeemed or were lapsed by August 31, 1962, so that chances of subsequent reduction of the 50-percent rate were either nonexistent, for the redeemed accounts, or presumably quite small for the lapsed accounts—which had paid 13 or fewer installments over the 3½-year period. At the other extreme, some 4.7 percent of the original accounts had prematurely completed all payments, so that their effective load had reached the 8.5-percent target.

TABLE XI–e.—*Effective sales charge paid by 1,437 sampled contractual plan accounts opened in February 1959 (as of Aug. 31, 1962)*

[Percent of all 1,437 accounts]

Effective sales charge as percent of amount paid [1]	Completed	Inactive			Active		All accounts
		Redeemed	Lapsed	Total	Reactivated	Active throughout	
All accounts	4.7	14.8	22.1	36.9	4.2	54.2	100.0
50.0		4.6	11.6	16.2	.5	.1	16.8
25.0 to 49.9		4.3	5.8	10.1	1.9	1.7	13.7
20.0 to 24.9		2.6	2.1	4.7	.6	4.4	9.7
15.0 to 19.9		1.5	1.3	2.8	.7	35.3	38.8
8.6 to 14.9		.5	1.3	1.8	.5	12.7	15.0
8.5	4.7						4.7
0		1.3		1.3			1.3

[1] Calculated on the basis of a 50-percent sales charge on the 1st 13 installments and a 4-percent sales charge on subsequent installments. While this approximates the predominant practice, it should be noted that the various plans require from 100 to as many as 200 installments to complete payment and achieve the 8.5-percent load level. Completed accounts alone are assumed to have reached the 8.5-percent load level, however. The effective sales charge for accounts having made the scheduled number of payments by Aug. 31, 1962, would amount to 17.6 percent.

cluding 2 installments in the first month) as scheduled. A 29-percent sales load has been deducted from his total payments. The second, by an initial prepayment pays 48 $50 units but makes no further payments. The average sales load on his payment amounts to about 16½ percent.

[220] One contractual plan sponsor requires payment of five initial installments.

[221] Custodial fees generally averaging 2 percent are excluded.

Among the accounts that were still active on August 31, 1962 (i.e., neither completed, redeemed nor lapsed), some 28.1 percent of the original planholders had paid more than 44 installments—the scheduled number, assuming that 2 installments were required for the initial payment (table XI-9). Though attrition may further thin the ranks of this group before the full schedule of payments is completed, a substantial portion of the group may be expected to approach the goal of an average of 8.5-percent load.

What remains of the February 1959 group—after the 1.3 percent who obtained a full refund, the 4.7 percent representing completed accounts which paid the target 8.5-percent load, the 16.2 percent who redeemed or lapsed having paid the maximum 50-percent load, and the 28.1 percent holders of active accounts who were ahead of their scheduled installments and, in most cases, likely to reach or approach an 8.5-percent load—is some 49.7 percent of the planholders for whom the current burden of the front-end load is somewhere between 8.5 and 50 percent. Among these were 19.4 percent lapsed or redeemed accounts, including 10.1 percent of all participants who had paid an effective load of between 25 and 50 percent, 4.7 percent who had paid a load of 20 to 25 percent, and the remaining 4.6 percent who had paid loads from 20 to 8.5 percent (table XI-9). There were also 30.3 percent active participants not ahead of the payments schedule. Of these, approximately 7 out of 10 had reached a 20-percent level of effective load, while the remaining 3 were in the 20- to 50-percent load category.

For the sample group purchasing contractual plans in February 1959 (aside from the 1.3 percent who redeemed with full refund), therefore, the effective sales charges after a 3½-year period emerge in the following pattern: one out of six purchasers (16.8 percent) paid a sales charge equal to 50 percent of his total payment, with little likelihood of subsequently reducing it to 8.5 percent. One-third of all purchasers were at the other extreme, some (4.7 percent) having reached the 8.5-percent load target through premature completion, others (28.1 percent) having exceeded their payments schedule with a good chance of eventually reaching the 8.5-percent target. Of the remaining half of the original planholders arrayed between these two extremes, 6.9 percent had redeemed with sales loads of from 20 to almost 50 percent, and another 2 percent had redeemed with loads mostly from 15 to 20 percent. As to the balance of 41.5 percent, one can only speculate on the likelihood of their eventually achieving the 8.5-percent sales charge level. Certainly for some portion of this group—which includes 10.5 percent lapsed accounts and 4.9 percent occasional investors behind by one-third or more of their scheduled installments—the prospects of reaching the 8.5-percent level are doubtful.

(2) *AMFPS statistics*

Statistical data presented by AMFPS in "The Origin and History of the Contractual Plan" and its 1961, 1962, and 1963 supplements consist of five different groups of data obtained from various sources and relating to separate aspects of contractual planholders' performance.

The first group of data relate to accounts terminated with losses. AMFPS obtained figures on all accounts opened by 35 "sponsors," 14 of which had been marketing contractuals for 5 years or more and

the remainder for less than 5 years. Consolidated figures covered the experience of 754,196 accounts opened between January 1, 1958, and December 31, 1962. While AMFPS notes that of these accounts only 8.06 percent terminated with losses, this figure represents an average of all accounts opened during the period, including 154,114 accounts opened in 1962 with respect to which there had been limited opportunity, in terms of time elapsed, for redemption. With respect to 117,366 accounts opened in 1958, which had therefore been in effect from 48 to 60 months at December 31, 1962, the figures show 18,561, or 15.81 percent terminated with losses. (This figure may be compared with the Special Study's sampling of February 1959 accounts which showed 13.5 percent of those accounts redeemed, without full refund, by August 31, 1962, after 43 months; the study's sample does not indicate what proportion of this number suffered losses.) The 1958 accounts reported by AMFPS show a steadily increasing number of terminations with losses during the first 3 years, followed by a drop in the fourth and fifth years: 1,737 (1.5 percent) in 1958; 2,795 (2.4 percent) in 1959; 5,360 (4.6 percent) in 1960; 4,725 (4.0 percent); and 3,944 (3.4 percent) in 1962.

The AMFPS statistics excluded accounts redeemed with gains prior to completion and a relatively small percentage of accounts that on termination elected to take down the underlying shares instead of cash, "since in such instances, the shares may be held indefinitely by the investor." The exclusion of these groups and the general emphasis on termination with loss reflects the industry view that the front-end load is justified by the ultimate aggregate profit of plan purchasers. The figures do not reflect, therefore, the sales charge paid by redeemed accounts as a percentage of the amount invested, regardless of gain or loss on redemption.

In a second set of statistical information emphasizing the overall long-range success of contractual plan purchasers, the AMFPS obtained statistics on cancellations of one nonmember sponsor covering all $25 monthly payment plans sold by it between January 1, 1949, and May 1, 1959, a 10-year-and-4-month period. This survey of 56,092 accounts showed that 5.7 percent had been canceled with losses, and 86 percent were still on the books, but it did not indicate how many of the latter were inactive or the relation of sales charges to the amount invested. The AMFPS concluded—

> that holders of the small denominations * * * do not discard their plans indiscriminately, nor is the sustained loss of those who terminate before completing their agreed payments, substantial.

To establish whether the same pattern applies to other denominations and companies, AMFPS compiled similar statistics on an aggregate of 70,921 accounts of $20, $50, and $100 monthly denomination 10-year plans sold by a different sponsor over the 23-year period beginning January 1940 and ending December 31, 1962. In summarizing its consolidated statistics, the AMFPS noted that 76 percent of the accounts were active [222] at December 31, 1962, 9 percent had been canceled with profits, and 15 percent had been canceled with losses. The figures indicate that the percentage of cancellations with losses was greatest in the lowest denomination plans:

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[222] For the purpose of this survey the AMFPS considered as active all accounts on the books of sponsors, whether or not any payments had been made in the preceding 12-month period.

TABLE XI-f.—*AMFPS record of active accounts terminated with profits or losses (as of Dec. 31, 1962)*

[Percent of all accounts]

23-year statistical record	All accounts	Accounts active	Accounts terminated before completing agreed payments	
			With profit	With losses
$20 monthly payment plan	100.0	72.1	10.0	17.9
$50 monthly payment plan	100.0	77.7	8.5	13.8
$100 monthly payment plan	100.0	79.3	8.5	12.2

Like the AMFPS figures on terminations with losses, the average figures are also affected by the inclusion of accounts most recently sold. For example, with respect to $20 monthly accounts opened in 1951, for all of which there was a full 10-year experience available, 24.1 percent were terminated with losses, 27.4 percent were terminated with profits, and 48.5 percent were still carried on the sponsors' books as active. No information is available which relates the sales charge paid on these plans to the amount invested.

The third group of AMFPS data relates to lapsed accounts, defined as those accounts which at December 31, 1962, had made no payments for over a year or more. The statistics are drawn from an analysis of the $50 monthly payment accounts of the sponsor which provided the statistics on cancellations discussed immediately above. The AMFPS analysis reveals that as of December 31, 1962, of 10,586 noninsured accounts [223] sold in the year 1944–61 which had not been terminated (36 percent of all such active accounts of this group on the books of the sponsor), 1,865 or 17.6 percent had made no payments for a year or more; aggregate payments on these lapsed accounts amounted to $2,494,100; the accounts had an aggregate liquidating value of $2,689,483; and 9.3 percent would, if liquidated, show a loss. The figures also indicate that in the aggregate, lapsed accounts initiated during 1957, 1958, 1959, 1960, and 1961 would be terminated with aggregate losses, while accounts initiated in 1956 or earlier would show a profit. The figures do not indicate how much sales charge was paid by the lapsed contractual plan purchasers.

The Special Study analysis of $50 accounts of this same sponsor started in February 1959, suggests some doubt as to the extent to which these figures may be regarded as representative of industry-wide performance, either for $50 plans or for plans of other denominations. At August 31, 1962, 5.7 percent of the $50 plans initiated by this sponsor in February 1959 were lapsed, using the same definition of "lapse" as used by the AMFPS. For all nine sponsors whose contractual planholders' performance was analyzed by the study sample, the percentage of $50 plans lapsed as of August 31, 1962, equaled 20.4 percent (table XI–10), while for plans of all denominations the percentage was 22.1 percent (table XI–5).

In a fourth group of data, the AMFPS further compares the relationship of aggregate scheduled payments on $50 monthly accounts due under 26,981 such accounts of the same sponsor (initiated during the 10-year period ended December 31, 1962) to the dollar amount

[223] No figures are given for accounts initiated with completion insurance, "owing to the compulsory effect the life insurance feature has on planholders in maintaining payments." Origin and History, 1963 supplement, p. 6.