Wendt

ADMINISTRATIVE PROCEEDING
FILE NO. 3-3718

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
PACIFIC SCHOLARSHIP TRUST	:
SPONSORED BY THE	:
PACIFIC SCHOLARSHIP FUND	:
(812-3020)	:
Investment Company Act of 1940	:

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW AND BRIEF IN SUPPORT THEREOF ON BEHALF OF THE DIBISION OF INVESTMENT COMPANY REGULATION

WILLIAM H. KLEH
Attorney

On the Brief:

HAROLD SWEETWOOD,
Special Counsel

November 10, 1972

Note: These Proposed Findings and Brief have been prepared by the Staff of the Division of Investment Company Regulation and constitute solely the Division's opinion with respect to the matters herein contained; they do not contain, and should not be construed as in any manner containing, an expression of the views of the Commission on any question pertaining to these proceedings.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

RULES AND REGULATIONS	Page(s)
Rule 23b-1 under Investment Company Act of 1940	20,41
Rule 15610-3 under Securities Exchange Act of 1934	35
Regulation S-X under Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940 Rule 6.10(d) and Rule 12.19	49

LEGISLATIVE HISTORY

Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. (1940)	33,51
Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies, Supplement on Companies Issuing Face Amount Installment Certificates (1939)	39
Report of The Securities and Exchange Commission, Investment Trusts and Investment Companies, Supplement on Companies Sponsoring Installment Investment Plans (1939)	23,24
Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, House Report No. 2337, 89th Cong., 2d Sess. (1966)	30,45

MISCELLANEOUS SOURCES

Kimball and Hanson, The Regulation of Specialty Policies in Life Insurance, 62 Mich.L.Rev. 167 (1963)	9,10
Securities and Exchange Commission, Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts ("The Wheat Report")	49
Investment Company Act Release No. 7220 (Guidelines for the Preparation of Form S-4 and S-5 Including the Prospectus for a Management Investment Company)(June 9, 1972)	49
Securities Exchange Act Release No. 9811 (September 27, 1972)	47
Trust Fund Sponsored by The Scholarship Club, Inc., File No. 811-1515-2, Notice of Special Meeting, October 4, 1971	37,44

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of PACIFIC SCHOLARSHIP TRUST SPONSORED BY THE PACIFIC SCHOLARSHIP FUND (812-3020) Investment Company Act of 1940	PROPOSED FINDINGS OF FACT AND CONCLUSION OF LAW AND BRIEF IN SUPPORT THEREOF ON BEHALF OF THE DIVISION OF INVESTMENT COMPANY REGULATION

Counsel for the Division of Investment Company Regulation requests that the Commission make the following findings and conclusions in this proceeding.1/

INTRODUCTORY STATEMENT

I. The Application

Pacific Scholarship Trust Sponsored by The Pacific Scholarship Fund ("Applicant") has filed an application, pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act"), requesting exemptions from the provisions of Sections 14(a) and 27(c)(1) of the Act, and pursuant to Sections 6(c), 18(i) and 23(b) for orders thereunder.

On May 24, 1972, the Commission (Investment Company Act Release No. 7196) ordered a hearing at which the following matters and questions were to be considered:

(1) Whether the granting of the requested exemptions and orders under the Act is (a) necessary and appropriate in the public interest, (b) consistent with the protection of investors, and (c) consistent with the purposes fairly intended by the policy and provisions of the Act; and

1/ References to the record are abbreviated as follows: App. - the application of Applicant; Br. - Applicant's brief; App.Ex. - Applicant's exhibits to the proceeding; Div.Ex. - the Division's exhibits; Tr. - the transcript of the hearing.

(2) If the requested exemptions and orders are to be granted, what conditions if any, should be imposed in the public interest and for the protection of investors.

The public hearing commenced on July 17, 1972 before the Honorable Sidney Ullman, Administrative Law Judge. Scholarship Investment Corporation ("SICO"), the servicing agent of Applicant, was granted leave to be heard. The hearing was concluded on July 21, 1972, but the record, which was ordered to remain open for the receipt of amendments to the application, was closed on September 15, 1972. An initial decision by the Administrative Law Judge was waived. Successive filings of proposed findings, conclusions and briefs were agreed to by the parties and ordered by the Administrative Law Judge.

II. Position of the Division

Based upon the record in the proceeding, it is the Division's position that the relief requested by the Applicant should not be granted.

FINDINGS OF FACT

Pacific Scholarship Trust ("Applicant" or "PacTrust"), which is sponsored by the Pacific Scholarship Fund ("PacFund"), was created in August 1971 by a trust agreement between PacFund and the Peoples National Bank of Washington ("Trustee"). (App.Ex. 8). In effect, PacFund consists solely of a board of directors who formulate the principal policies of the trust and perform general supervisory functions. (Tr. 558-561). 1/ Applicant has registered under the Act as a closed-end, non-diversified, management investment company. (File No. 811-2225). Scholarship Investment Corporation ("SICO"), a profit-making corporation, has contracted for the sale and administration of Applicant's scholarship plans. (App.Ex. 13). As an independent contractor, SICO is authorized to perform similar functions for other entities, and is currently conducting a training course for prospective securities salesmen. (Tr. 565-566).

It is contemplated that each investor in Applicant will make a single payment or periodic payments pursuant to a plan which is created for the benefit of a child. These payments will be received and distributed by the National Bank of Commerce of Seattle ("Custodian"), pursuant to a Custodian Trust Agreement. (App.Ex. 5). Applicant has provided for six different plan types, including three fully-paid plans and three installment plans. The plan types vary with respect to the size of each payment and the duration

---

1/ Applicant has emphasized the legal status of PacFund as a non-profit corporation under Washington law. (Br. 26) (App.Ex. 34) Each planholder's membership certificate refers to the non-profit nature of the plan sponsor. (App.Ex. 22). This fact might tend to mislead investors, however, since the plans are intended to yield a profitable return to SICO, the plan's administrative and sales corporation.

of the savings deposit period.1/

After deduction of sales and administrative charges, the balance of each payment is deposited by the Custodian into higher interest-bearing savings accounts of the Custodian and other savings institutions.2/ By the terms of the investment agreement between each planholder and PacFund, the planholder irrevocably assigns the earnings from his savings account for transfer annually to PacTrust. (App.Ex. 3, § 4.2.3). Each investor must pay taxes on all transferred savings account earnings, even though such amounts may be later forfeited. (App.Ex. 3, § 4.2.2; Tr. 548-549). These transferred amounts are invested by the Trustee bank in conservative securities, including high-grade municipal bonds and government bonds, savings accounts and certificates of deposit. (App.Ex. 3, § 4.3.3; App.Ex. 8, ¶ 3). The total amounts accumulated in the Trustee bank, including any additional gains resulting from the forfeitures of other plans, constitute the planholders' investment accounts, and form the source of Applicant's scholarship payouts to its plan beneficiaries.

Each scholarship planholder exercises complete control over the balance of his savings account, but a withdrawal of any money from this account prior to completion of the deposit period will result in a forfeiture of the

---

1/ The plan types are structured so that they will ultimately yield equal earnings into the trust. (Tr. 296-298). Plans A, B, and C are installment plans. Plan A provides for payments at $20 per month over a period of 12 years. Plan B provides for $30 per month for ten years; and plan C, $45 per month for 8 years. Plan D, E and F are fully-paid plans. Plan D provides for a single payment of $1,796.50 to be deposited for 9½ years. Plan E requires a deposit of $1,996.50 for 8½ years; and plan F, $2,196.50 for 7½ years. (App.Ex. 4).

2/ Under the Custodian Agreement, the Custodian will be compensated by SICO out of the administrative charges which are deducted from investors' payments. To the extent that savings account balances are retained by the Custodian bank, SICO will benefit from a reduction in the Custodian's fee. However, this reduction will not be reflected in lower administrative charges to planholders. (Tr. 546-548).

investor's investment account. (App. Ex. 3, ¶11.2). Similarly, an investor can forfeit his trust account balance if he fails to make prescribed payments under an installment plan, or if he fails to supply PacFund with any required reports. Most importantly, a PacTrust account can be forfeited if the child-beneficiary of the plan fails to enter or to continue a prescribed college program. (App.Ex. 3, ¶7; Tr. 422-425). In addition to the loss of sales and administrative charges,1/ a planholder who forfeits his investment account will lose his total savings account earnings previously transferred to the trust, together with reinvestment earnings and amounts gained from lapses of other trust accounts. The following table sets forth the losses which investors in plans A and D would experience in the event of a forfeiture at the end of each year of participation.

1/ Total sales loads on any installment plan certificate do not exceed the 9% limitations of Section 27(a) of the Act. (App.Ex. 9, pp. 15-23). However, in the case of any plan type, total loads are equal to 23% of the total amount which is transferred under the plan from the savings account into PacTrust.

PACIFIC SCHOLARSHIP TRUST - PLAN A [1/]

Year of Participation	Total Payments	Cumulative Sales Loads	Cumulative Admin. Charges	Cumulative Earnings [2/]	Amount Forfeited	Forfeitures as % of Payments
1	$ 240	$ 48.00	$ 21.50	$ 3.66	$ 73.16	30 %
2	480	96.00	39.50	14.37	149.87	31 %
3	720	141.50	48.50	32.40	222.40	31 %
4	960	141.50	52.50	59.03	253.03	26 %
5	1,200	141.50	56.50	95.24	293.24	24 %
6	1,440	141.50	60.50	141.03	343.03	24 %
7	1,680	141.50	64.50	196.40	402.40	24 %
8	1,920	141.50	68.50	261.35	471.35	25 %
9	2,160	141.50	68.50	335.88	545.88	25 %
10	2,400	141.50	68.50	420.15	630.15	26 %
11	2,520	141.50	68.50	513.25	723.25	29 %
12	2,520	141.50	68.50	607.58 [3/]	817.58	32 %

1/ The information contained in this table is taken from Applicant's registration statement. App.Ex. 9, p. 14-15.

2/ Cumulative earnings include only those amounts which have been transferred from the planholder's savings account in Custodian, and do not include reinvestment earnings in PacTrust. In addition, they do not include any amounts forfeited from other lapsed accounts. Earnings are based on annual interest rates of 4%.

3/ Savings left on deposit for 18 months.

PACIFIC SCHOLARSHIP TRUST - PLAN D [1]

Year of Participation	Total Payments	Cumulative Sales Loads	Cumulative Admin. Charges	Cumulative Earnings [2]	Amount Forfeited	Forfeitures as % of Payments
1	$1,796.50	$ 141.50	$ 55.00	$ 64.96	$ 261.46	15 %
2	1,796.50	141.50	55.00	129.92	326.42	18 %
3	1,796.50	141.50	55.00	194.88	391.38	22 %
4	1,796.50	141.50	55.00	259.84	456.34	25 %
5	1,796.50	141.50	55.00	324.80	521.30	29 %
6	1,796.50	141.50	55.00	389.76	586.26	33 %
7	1,796.50	141.50	55.00	454.72	651.22	36 %
8	1,796.50	141.50	55.00	519.68	716.18	40 %
9	1,796.50	141.50	55.00	584.64	781.14	43 %
10 [3]	1,796.50	141.50	55.00	617.12	813.62	45 %

1/ The information contained in this table is taken from Applicant's registration statement. App.Ex. 9, p. 20.

2/ Cumulative earnings include only those amounts which have been transferred from the planholder's savings account in Custodian, and do not include reinvestment earnings in PacTrust. In addition, they do not include any amounts forfeited from other lapsed accounts. Earnings are based on annual interest rates of 4%.

3/ Six months only.

According to PacFund's currently proposed method of distribution, all amounts which are forfeited from a lapsed investment account will be allocated to surviving accounts on the basis of each account's proportional share of the total assets of PacTrust. Savings account balances will be disregarded for purposes of the allocation. (App.Ex. 3, § 5.1). The Division's expert witness, Mr. Michael Virga, an actuary with the Division's staff, prepared tables which demonstrate that this method of allocation will lead to inequitable results, since planholders who purchase plans for their children while they are still very young will complete their deposit periods early and will be able to leave their investment account balances in the Trustee Bank until such time as their children enter college.1/ Div.Ex. 4; Appendix I) As a result of this additional period of investment, or any delays permitted by PacFund, the delaying investor's account will consume a disproportionately greater share of earnings and forfeitures. The net result is that a student in Plan A who does not enter college until five years after the end of his savings account deposit period, will receive $1,646.81 each year, or 2-1/2 times the annual gains of a student in the same plan who enters college immediately following the end of his deposit period. In the case of an eight-year delay, the total payouts would be $2,678.34 per year, or almost quadruple the gains of a plan which is completed just prior to the beneficiary's enrollment in college.2/

1/ The exhibit is based on the same forfeiture and dropout assumptions that are contained in Applicant's Exhibit 10, except that the Division's model assumes that continuous sales are made of only one plan type. (Tr. 693-694).

2/ An eight-year delay could result, for example, in the case of a plan purchased for the benefit of a one-year old child, where the savings period is completed by the time the child is nine, but the investment account is left to accumulate additional earnings and forfeitures until the child enters college at age seventeen. (Tr. 699)

Another possible source of inequity among investors arises from the fact that those investors who enroll during the first few years of PacFund's operations would not be able to participate in the allocation of the larger forfeitures which result when students drop out of college. On the other hand, those investors who purchase plans after the trust has been in existence for over twelve years would participate in these larger forfeitures throughout the terms of their plans.1/

At the termination of each plan's savings account deposit period, the planholder may withdraw the principal of his savings account and use this amount for any purpose which he chooses. His investment account balance will continue to accumulate earnings and forfeitures until such time as the child-beneficiary is ready to enter his second-year of post-high school education. While it is contemplated that the principal of each plan savings account will be used to meet the expenses of the student's first year in college, there is no requirement that it must be used for this purpose. (Tr. 688-690). On the other hand, the planholder's investment account balance can only be used to meet the qualifying expenses of the beneficiary's higher education. (App.Ex. 3, §6.1.2).2/ If the student attends a two-year community college, he will be entitled to receive amounts up to the full balance of his investment account, provided that such amounts do not exceed his qualifying expenses. (Tr. 670-673). Surplus amounts would be forfeited to other investors. (Tr. 666-669). A student in a four-year school would receive one-third of his total investment account balance at the

---

1/ For example, if only one investor purchased Plan C, an eight-year plan, in the first year of operations, and all other investors in that year purchased twelve-year plans, the eight-year plan would never stand to gain the larger amounts which are forfeited by students dropping out of college.

2/ These expenses include tuition, room, board, academic fees and generally, any allowances which must be necessarily incurred by the student in school. Payouts would be made directly to the school for the benefit of the student.

commencement of his second year. (App.Ex. 3; §6.2). Although Applicant has stated that the size of payouts from the plans will not be affected by any outside scholarships which the beneficiary receives, it is not clear whether the receipt of money from another source would indirectly result in a lower award by reducing the total qualifying expenses which the student would need to pay. (Tr. 675).

Applicant's plans include provisions governing substitution, delay, and changes in school program. (Tr. 426-434). A person may be substituted for a designated student-beneficiary at any time before the student's tenth birthday, or in the event of his death if it occurs after the second year of college. (App.Ex. 3 §9). Students may delay their college program for any of several reasons designated by PacFund, including temporary illness, military duty or any other activity which is approved by the board. (App.Ex. 3, §8). Applicant's plan provide for a wide range of school programs in which eligible beneficiaries may enroll (App.Ex. 3; §6.1.1), and there is provision for transfers between school programs. (App.Ex. 3, §8.2). In accordance with the investment agreement, investors may transfer their rights under a plan, including the right to make payments to the Custodian, to withdraw the principal of the savings account, and to substitute beneficiaries subject to the limitations discussed above. (App.Ex. 3, §11; Tr. 514).

Applicant has developed certain suitability guidelines which will govern the sale of its scholarship plans.1/ Plans would only be sold to

1/ Applicant's proposed suitability controls have been somewhat modified by its latest amendment to the application, which was filed after the close of the hearing. The Administrative Law Judge received the amendment as the Application in the proceeding, but declined to take official notice of the amendment. Accordingly, Applicant's latest filed proposals have not been admitted as evidence in the proceeding. Nevertheless, for purposes of its proposed findings, the Division accepts Applicant's representations as to future suitability controls. However, the Commission should disregard the information contained in Applicant's Appendix IV to its Findings of Fact, since this information has not been received as evidence in this proceeding.

residents of the State of Washington whose annual income exceeds $6,000, although it is intended that the principal thrust of SICO's sales effort would be directed to "investors over 30 year of age, making over $9,000 annually (plus $1,000 for each dependent in excess of two), who have had (or whose spouse has had) some formal post-high school education, and who are considered white-collar workers." (App. 25-26). Before completing a sale, the sales force would be directed to consider additional factors such as the educational and professional background of the investor, and the physical and mental health of the child. (App. 19-20). A prospective purchaser's indication of commitment to complete plan requirements would be an important factor in determining whether the sale would be approved. (Tr. 509-516). The salesman would possess some discretion in deciding whether to complete a sale, although questionable cases would be left to the final determination of the sales manager at SICO's home office. (App. 20; Tr. 507-508).

There are no minimum age requirements for child-beneficiaries of plans (Tr. 512), and there are no maximum family income levels above which plans would not be sold. (Tr. 505). In addition, PacFund has not prohibited the sale of more than one plan for the benefit of the same child. (Tr. 541).

SICO's sales force will include both full-time and part-time salesmen. (Tr. 522). There is no requirement that they have previous experience as securities dealers or insurance agents, although they will be referred to as "counselors" and will advise prospective planholders with respect to alternative investment possibilities. (Tr. 521-523). Both the counselors and the sales managers will be compensated on a commission basis, including bonuses, based strictly on the number of plan sales. (App.Ex. 17).

In connection with Applicant's proposed suitability controls, the Division's expert witness, Mr. Walter Adams, a staff associate of The Bureau of Applied Research at Columbia University, recently completed a report for submission to the United States Office of Education, which demonstrates statistically significant variations in the college attendance and dropout rates of students in relation to their sex, family income levels, the professional and educational background of their partents, and the nature of the community in which they live. (Div.Ex. 2; Tr. 571-591). The statistics contained in this report are based on a survey conducted by the United States Census Bureau on the educational experience of 1965 graduating high school seniors from 50,000 randomly selected families throughout the country. Mr. Adams testified that the statistics reveal that 48% of those students in families earning annual incomes of less than $10,000 will fail to enter college, as compared to a 26% failure rate for students in families at higher income levels. (Tr. 575). Large differences likewise occur between family income levels of $10,000 and $15,000. (Tr. 599). Similarly, a higher proportion of students from lower income families will drop out of college as compared to students from higher income families, and delays in college attendance will not significantly alter these results. (Tr. 578).

These figures indicate that there is a great likelihood that Applicant's plans will be sold to persons with significantly different chances of success. Thus plans could be sold to very wealthy families, including, for example, families residing on Mercer Island, a wealthy suburb of Seattle. Applicant has introduced statistics which show that 87% of the students graduating from Mercer Island schools in 1966 would have been eligible for payouts under a scholarship plan.1/ (App.Ex. 12; Tr. 308-310). Mr. Adams testified that this is an extraordinarily high percentage of students attending college, but that the statistics bear out the wealth of the community. (Tr. 590-591). Thus Mercer Island students would be much more likely to receive benefits under a plan than students in less well-to-do communities.

The study also reveals statistically significant variations in other categories. A higher incidence of females will fail to attend college than males (Tr. 580-582); and the children of blue-collar workers will be much less likely to enter college than the children of white-collar workers. (Tr. 583-584). The widest variations occur with respect to the level of the parents' education. In the case of parents with less than a high school education, two-thirds of the children did not attend college. By contrast, only 13% of the children of college graduates failed to enter college. (Tr. 587-589).

In order to demonstrate the benefits which will be likely to result from scholarship plans, Applicant introduced projections that plans would yield an average return equal to $750 per year to each planholder who completes his plan, and whose child-beneficiary finishes his college program. Applicant's expert witness, Mr. Gary Larson, a consultant for Price Waterhouse and Company, reviewed the methodology of Applicant's projections, and concluded that their projected payouts were probably

---

1/ On cross-examination Mr. Gill testified that this percentage would probably be higher since some students would be able to take advantage of Applicant's liberal rules governing permissible delays and substitutions.

conservative, and that the average benefit could be expected to reach $780 per year. (App.Ex. 30; Tr. 253-254). However, Mr. Larson did not test the assumptions upon which the projections were based.

A careful examination of Applicant's assumptions leads to the conclusion that the average annual payout is likely to be much lower than $750. In In the first place, Applicant's projections were calculated prior to the imposition of any suitability controls on SICO's marketing practices.1/ If sales are restricted to higher income groups and to families who are unlikely to forfeit except in the case of "normal student attrition" after children enter college, it is probable that the forfeiture rate will be much lower than originally assumed. Second, Applicant's Exhibit 10 does not include any major adjustments for the incentives which will supposedly result from a plan investment. Mr. Gill testified that if incentives had been taken into account in the model they would not have had an appreciable effect on the projected payout figures, despite Applicant's representations that its plans will provide incentives for students to continue their education. (Tr. 657-658). Third, Applicant's projections do not take into account the large numbers of Washington students who are likely to take advantage of the state's community college program.2/ (Tr. 372). This would result in a much lower forfeiture rate, although the

---

1/ The projections contained in Exhibit 10 were prepared prior to January, 1972. (Tr. 291). Suitability controls did not appear in the original application which was filed in September, 1971. The first mention of suitability is contained in Applicant's amended application dated February 2, 1972, and substantial attention was not given to suitability until the third and fourth amendments which were filed after the close of the hearing.

2/ A letter dated July 11, 1972, from Alan Metcalf, Research Director for the State Superintendent of Public Instruction, to Mr. Gill, states that approximately half of the graduating class of 1970 attended community or junior colleges. (App.Ex. 11-A).

corresponding reduction in the size of payouts would be offset to some extent by the larger amounts forfeited by community college students whose plan account balances exceed their qualifying expenses. Fourth, there is no empirical data to support Applicant's assumptions with respect to number to number of plan sales, projected mix between plan types sold, or projected rates of forfeitures in plans during the accumulation period. Applicant also appears to make no adjustments for the transferability of plans by investors. In addition, Applicant's projections assume identical forfeiture rates for installment plans and fully-paid plans during the later years of a plan's pay-in period. Mr. Gill testified that these figures were based in part on the experiences of the Florida plans, yet the prospectus for those plans reveals that the forfeiture rate for installment plans was almost 3-1/2 times the rate for forfeitures of fully-paid plans. (App.Ex. 27; Tr. 649-652). Finally, the college attendance and dropout rates appear to be somewhat arbitrarily determined.1/ It is significant that none of these figures takes into account the potential

---

1/ These assumptions were largely based on figures supplied by the Department of Health, Education and Welfare. (App.Ex. 10). The national figures may or may not be accurate for the state of Washington. Beyond the broad statement that the assumptions are reasonable in light of this data, Applicant has not indicated the precise correlation between these official statistics and the figures underlying its projections. While Applicant claims to have compared these nationwide figures with statistics for the state, most of the Washington figures were not received by Applicant until long after its projections were calculated. (Applicant's Exhibit 10-B, a draft report by the State Council on Higher Education, is dated July, 1972). In addition, much of the Washington data relates to retention rates and enrollment patterns among Washington schools, and does not provide the more relevant information about Washington students. See, for example, Table 3 "Retention of Students" following the payout projections in Exhibit 10.

effect of Applicant's liberal delay and substitution provisions. These factors would further drastically reduce the forfeiture rate and the projected average annual payout from successful plan accounts.

Even if Applicant's assumptions are accepted as correct, it is likely that only a relatively small portion of planholders will gain an advantage from an investment in the plans as compared to a savings account deposit. On the basis of the forfeiture and dropout rate assumptions which are built into Applicant's Exhibit 10, the Division's expert witness, Mr. Virga, prepared tables demonstrating what a group of 10,000 investors would be likely to gain or lose from an investment in Plan A or Plan D as compared to the results of a similar investment in a savings account earning interest compounded at 4%. (DivEx. 5 Appendix II).1/ The tables reveal that an investor in Plan A would stand to lose a maximum of $1,103.49 if the plan is forfeited at the end of his child's freshman year in college. If the child completes the plan by entering his fourth year, the investor will have gained $1,196.34 more than a comparable investment in a savings account. The tables reveal that the only plan accounts which will receive a net gain over a savings account experience are those plans which are owned for the benefit of students who continueas far as their junior year in college. Since 34% of the group will attain this level, only that portion will stand to gain from a scholarship plan investment. (Tr. 711).2/

1/ Applicant's projections were based on an investment rate of 5%. Mr. Virga adjusted the savings account rate downward to 4% to reflect the fact that Applicant would probably be able to achieve higher earnings by pooling investors' funds and depositing them in higher-yield savings accounts. (Tr. 704).

2/ Applicant has criticized this kind of analysis because it compares potential losses with actual gains. (Tr. 352). In fact, this approach does no more than explore the opportunity cost of an investment in scholarship plans. An identical analysis was followed by the Commission in its 1939 Investment Trust Study, in which investments in periodic payment plans were compared to savings account deposits over the same period of time. Securities and Exchange Commision, Report on Investment Trusts and Investment Companies, Supplement on Companies Sponsoring Installment Investment Plans (1939), p. 60.

If Applicant receives the exemptions which it needs in order to sell its plans, it will be only the second registered scholarship trust to operate in the United States. The Trust Fund Sponsored by the Scholarship Fund, Inc. sold plans in Florida from 1962 until 1967, at which time sales were discontinued until the fund received certain exemptions from the Act and registered its plans with the Commission. Sales were resumed in October, 1969. (App.Ex. 27, p. 15)

The record discloses the forfeiture and payout experience of the Florida plans. From 1962 until December 31, 1971, the Trust Fund experienced a lapse rate equal to 48.4% of all installment plans, and 13.9% of all fully paid plans which were sold during the period. (App.Ex. 27, p. 17) Although these figures reveal that a relatively large percentage of planholders forfeited their shares of the earnings of the trust, the actual amount of forfeitures which were allocated to remaining planholders were quite small, apparently for the reason that a majority of defaults occurred during the early months of the plans. As a result of forfeitures, only $97,014.69 was made available to 5384 outstanding plans, or an average allocation of slightly more than $18 per plan. (App.Ex. 27, p. 17) In September, 1971, the first class of eligible beneficiaries received payouts from the trust. The "scholarships" which were awared to this initial class of three students totalled only $780, or approximately $260 per student for the second year of college.1/ (App.Ex. 27, pp. 25, 35) Even though these plans were able to reap the benefits of ten years' earnings and forfeitures, they only

---

1/ The record reveals that the average investment into these early plans was a $25 monthly payment for a period of ten years. The total cumulative deposit into the savings account equalled $3000. (App.Ex. 27, p. 26) These figures are comparable to the amounts invested under Applicant's plans.

yielded sums which would pay for only a small portion of the beneficiaries' college expenses.1/

Applicant's plans would be subject generally to the Blue Sky law of the State of Washington. (App.Ex. 32). In addition, PacFund has delegated certain authority to the state securities administrator relating to approval of changes in the administrative charges under the plans and to the use of amounts accumulated in Applicant's reserve trust system. (Tr. 688). By contrast, the Scholarship Club Trust Fund in Florida is licensed under a statute which specifically regulates scholarship trusts. (App.Ex. 31). The law gives the state treasurer broad authority to grant and revoke licenses to sell plans in the state. A $50,000 deposit with the state authorities is required to ensure the trust fund's ability to meet its obligations under the plans.

1/ The current prospectus of Canadian Scholarship Trust Plan reveals similar results. (App.Ex. 26, p. 12). Each child who qualified for a scholarship in 1971 received $266 from the trust's earnings. However, this amount was supplemented to yield an award of $700 per child. The supplements were paid out of the Trust's General Fund. Applicant's plans do not provide for similar supplements in the event of a low investment return.

BRIEF AND CONCLUSIONS OF LAW

I. Provisions Under Which Exemption Is Sought.

The application for exemptions is based principally on Section 6(c) of the Act, 1/ which provides in relevant part:

> The Commission. ... by order upon application, may conditionally or unconditionally exempt any person, security, or transaction or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

The Applicant bears the burden of justifying the exemptions it seeks. 2/ This burden is particularly heavy under Section 6(c) of the Act, because the language of that provision requires a positive demonstration that its standards are satisfied. 3/

With respect to Section 6(c), the Commission has stated:

> This section was designed to afford discretionary authority to provide exemptions from provisions where it appears in the light of unusual or unanticipated circumstances of a particular case that compliance with such provisions is not necessary to accomplish the objectives and policies of the Act. Such authority must not be exercised in a manner which would permit the basic objectives of the Act to be thwarted. 4/

1/ Applicant has also requested orders under Sections 18(i) and 23(b) of the Act.

2/ Schlemmer v. Buffalo, Rochester, and Pittsburgh Ry. Co., 205 U.S. 1, 10 (1906); Hartford Gas Co. v. Securities and Exchange Commission, 129 F.2d 794, 796 (2d Cir. 1942); Electric Bond & Share Co. v. Securities and Exchange Commission, 92 F.2d 580, 592 (2d Cir. 1937)

3/ This conclusion is supported by a comparison of the 6(c) test with the provisions of Section 3(d) of the Public Utility Holding Company Act of 1935, which requires only that the Commission find that the requested exemption is "not contrary to the purposes" of the statute.

4/ The Variable Annuity Life Insurance Company of America, 39 S.E.C. 680, 685 (1960).

Thus, the propriety of granting any exemption under Section 6(c) will largely depend upon the purposes of the section from which exemption is sought. 1/

In considering the application of the specific provisions of the Act to a particular situation, it is necessary to refer to Section 1(b) of the Act which contains the Congressional declaration of policy with respect to the purpose of its enactment. That section states in pertinent part:

> . . . it is hereby declared that the national public interest and the interest of investors are adversely affected - -
>
> (1) when investors purchase, pay for, . . . or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities. . .;
>
> *　　　*　　　*
>
> (3) when investment companies issue securities containing inequitable or discriminatory provisions. . .;
>
> (4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed. . .;
>
> *　　　*　　　*
>
> (8) when investment companies operate without adequate assets or reserves.

Moreover, the last sentence of Section 1(b) sets forth a canon for construction of the Act:

> It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

Applicant has requested exemption from the provisions of Sections 27(c)(1), 23(b), 18(i) and 14(a). However, the provisions of Applicant's plans also require exemption from Section 23(c) and Rule 23c-1 thereunder.

1/ First National City Bank, Investment Company Act Release No. 4538, p. 6 (March 9, 1966); Transit Investment Corp., 28 S.E.C. 10, 17 n.20 (1948); American Participations, Inc., 10 S.E.C. 431, 435 (1941).

II. Section 27(c)(1).

A. The Purposes of the Section.

Section 27(c)(1) prohibits any registered investment company issuing periodic payment plan certificates from selling any such certificates unless they are redeemable securities. An exemption from this section is crucial to the sale and operation of Applicant's scholarship plans, because a redeemability requirement would remove the possibility of plan forfeitures and thereby eliminate the major source of accretions to an investment in the plans. The essence of Applicant's plans is their forfeiture provisions. In the absence of forfeitures, scholarship plans could not be sold in their present form, since investors would be unlikely to purchase plans without the possibility of realizing sufficient sums to pay for a significant portion of their children's college expenses.1/ Applicant itself has represented that forfeitures are necessary to achieve the purpose of the plans. (Tr. 20-23).

Applicant has argued in its brief that since the legislative history of the Act does not clearly state the purpose of a redeemability requirement in the case of periodic payment plans, it must be concluded that

---

1/ For example, in the absence of forfeitures, an investor in Plan A could only gain the savings account earnings equal to about $607, plus any additional reinvestment earnings on this amount. This total would need to be reduced by $210, the amount of sales loads and administrative charges which he pays. Taking forfeitures into account, Applicant has projected an average annual return of $750 per year for each year that the child-beneficiary attends college. (App.Ex. 10). Applicant's expert witness, Mr. Gary Larson, testified that an average of 25% of all plans would need to forfeit before the remaining investors would be able to realize gains equivalent to a comparable deposit into a savings account for the same period of time. (Tr. 262).

Section 27(c)(1) is not a "cardinal provision of the Act." (Br. 18). In effect, Applicant contends that the absence of any clear statement of Congressional intent in respect of the section requires "proof of a negative that the evils actually considered were not dependent on redeemability or nonredeemability." (Br. 5). After reviewing the legislative history of periodic payment plans, Applicant concludes that the evils associated with the plans would not be corrected by redeemability; and further, that the abuses which existed at the time of passage of the Act cannot possibly arise in the operation of scholarship plans. (Br. 5-17).

Aside from the lack of merit of this argument, Applicant's approach misconceives the nature of its burden under Section 6(c). Instead of making a positive demonstration in support of the exemption which it seeks, Applicant has attempted to shift the burden to the Division to justify a provision of the Act which is plainly stated, and which literally applies to Applicant, a registered investment company issuing periodic payment plan certificates.1/

Section 27(c)(1) is designed to prevent forfeitures and to ensure that investors in periodic payment plans can obtain at any time the full value of their underlying investment. The legislative history of the abuses of pre-Act periodic payment plans revealed the need for an anti-forfeiture provision which would supplement statutory limitations on the sales loads which are deducted from payments under the plans.

1/ In The Trust Fund Sponsored by The Scholarship Club, Inc., (Investment Company Act Release No. 5524), the Applicant argued that its plans were not periodic payment plans as defined in Section 2(a)(27) of the Act, since the investor acquired no undivided interest in Applicant's assets until his beneficiary qualified for a scholarship, at which point his interest is in effect redeemable to the extent of the beneficiary's college expenses. The Commission stated that it did not accept this argument, but granted the exemption on other grounds. (Investment Company Act Release No. 5524, pp. 8-9).

Thus there would be little sense in curtailing sales loads if plan sponsors could devise other methods of deriving fees and charges from plan accounts. The legislative history contains ample evidence of undesirable plan charges which were deducted from the net asset value of the investor's account, and which could not be removed by means of a percentage ceiling on sales loads. Thus some plans deducted a fee from the subscriber's investment if he withdrew from the plan prior to completion of his payments. The Commission's 1939 Investment Trust Study reported:

> Withdrawal fees on termination were of two kinds, ostensibly assessed with different purposes in view, although both served as a deterrent to the investor's withdrawal from the plan and the liquidation of his account and both added to the sponsor's profits. Under some installment investment plans, a fixed amount was deducted from the proceeds of the subscriber's investment if he withdrew from the plan prior to the completion of the agreed payments. This type of fee was commonly not large and presumably was intended to cover the cost of liquidation and withdrawal. Another point of view, however, suggests that this charge was merely a penalty for withdrawal, designed to restrain the certificate holder from terminating his payments and liquidating his account before completion of the plan.
>
> Another type of withdrawal fee existed in those plans in which the sponsor's fee was equally prorated over the entire period of the plan and not appropriated by the sponsor in the first months of the plan. In order to assure to itself payment of a fee comparable in amount to the service fee charged in the usual plan despite early discontinuance of the plan by a subscriber, the sponsor devised an arrangement whereby at liquidation a fee was deducted from the proceeds of the investor's account.1/

Since these charges are not taken from the investor's payments into the plan, they are not "sales loads" within the meaning of the Act, and are

---

1/ Securities and Exchange Commission, Investment Trust and Investment Companies, Supplement on Companies Sponsoring Installment Investment Plans (1939), p. 37.

not regulated by the load limitations of Section 27(a).1/ A redeemability requirement, on the other hand, prohibits these undesirable penalty charges, since the investor would always be "entitled to receive his proportionate share of the issuer's current net assets."2/ It is clear, therefore, that Section 27(c)(1) was aimed at a particular abuse in the pre-Act industry, which could not be remedied by any other provision in the Act.

Scholarship plans would revive these earlier abuses, since forfeitures effectively reduce, if not eliminate, a planholder's net asset value. There is also a close similarity between the pre-Act plan "penalties" for early termination, and the modern scholarship plan "incentives" toward completion. The Commission should not be misled by euphemistic terminology. The disguise of a worthwhile objective cannot obscure the penalty aspect of Applicant's forfeiture provisions. In this context, the Commission's study of the sales practices of periodic payment plans revealed that plans were often promoted as a means for providing for the expenses of the college education of an investor's child.3/ The Commission also noted the misleading sales practice of making projections of likely returns from a plan investment.4/

1/ Section 2(a)(35) defines "sales load" as "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received for investment or held for investment by the issuer..."

2/ Section 2(a)(32) of the Act.

3/ S.E.C. Investment Trust Report, Supplement on Installment Investment Plans, 168.

4/ Id. at 171-175. While Applicant has stated that no projections will be contained in its prospectus, the information contained in Exhibit 10 may be presented to prospective planholders as long as it is fairly presented. Also Mr. Gill testified that the Calculator in Exhibit 35 might be used at some time in the future. (Tr. 681-682).

In spite of these similarities, the earlier periodic payment plans which created the need for corrective legislation were in many respects safer investments than scholarship plans, despite their heavy sales loads, since a subscriber needed only to complete his plan in order to receive his full net asset value, and he would always be entitled to receive a major portion of his investment. He did not need to meet any further contingency such as the requirement that his son enter the second year of college. In addition, the penalty charges which were assessed against pre-Act contractual plan accounts were minimal in size, and tended to decrease as the investor continued to make payments under his plan.1/ On the other hand, scholarship plan forfeitures result in the loss of the investor's entire interest in the trust. The more that the investor contributes to his plan, the more that he stands to lose in the event of forfeiture.

Previous exemptions from Section 27(c)(1) have been granted to companies issuing variable annuity contracts so as not to require redemptions during the payout or annuity period of the contract. These exemptions were granted, not to permit forfeitures, which was one of the primary legislative concerns underlying the provisions, but to give the investor-policyholder the type of insurance protection for which he had contracted. Insurance companies cannot effectively guarantee annuity payments for the life of any policyholder unless certain mortality assumptions can be reflected in the amounts of each payout. In

---

1/ Charges tended to range in the neighborhood of $5 or $6 at the time of withdrawal. This compares to a maximum forfeiture of $607.58 in the case of Applicant's plan A, exclusive of sales load, administrative charges, reinvestment earnings and other accruals, which are also forfeited by the planholder.

The Prudential Insurance Company of America,1/ the Commission stated:

> With respect to the non-redeemability of the contracts during the pay-out period, we recognize that the very nature of the variable annuity arrangement entails mortality assumptions and undertakings on the part of Prudential which would be adversely affected by the unilateral withdrawal of unliquidated units by an annuitant during the annuity period. Non-redeemability comes into play only after a specified interval during which redemption is permitted and serves to make the life-annuity feature feasible.2/

The Division had argued that this exemption should be denied because of Prudential's use of an assumed investment rate which did not include capital gains or losses, and which therefore discriminated against annuitants who died early and could not receive a fair share of their investment. The Commission replied to this argument as follows:

> We do not accept the Division's position here. We do not consider the formula proposed to be inherently unfair or inequitable. To the extent that actuarial factors are involved in the application of the investment assumption, they will be subject to the regulatory scrutiny of the state insurance commission.3/

Applicant has repeatedly emphasized the insurance-like protection which is afforded by scholarship plans. Applicant's principal witness, Mr. Edward Gill, the president of SICO, testified that this protection was one of the main purposes for the plans:

> We see the plans as being a pooling of funds not unlike insurance in this respect in that the investor as he purchases a plan is in effect insuring himself against the risk of his student going on to college. If indeed the student goes on, then he must have funds to help meet that risk, and these would be the funds from PacFund plans that would do this. If, then,

---

1/ 41 S.E.C. 335 (January 22, 1963).

2/ Id. at 354.

3/ Id. at 354, note 48.

> the student does not go on to college, he would not have the need; thus, under the provisions of the plan would forfeit certain monies that have accrued in his and the student's name, and these would be made available to the other students. (Tr. 21-22).

Applicant's plans are not insurance, and would not be regulated as such. Under insurance contracts, the insurer ultimately bears the risk by guaranteeing a specified level of benefits.1/ In scholarship plans, the risk that the investors will incur the expenses of their children's college education is directly borne by the investors themselves. The planholder does not secure himself against the particular risk; he speculates on the likelihood that his own child will succeed, and gambles that a number of other investors' children will fail to enter college.2/ Thus investors are pitted against one another in pursuit of their goals.

Applicant has further compared its plans to variable annuity contracts, (Br. 21). However, there are important differences between these two forms of investment. During the pay-in period, a variable annuitant is always entitled to the underlying net asset value of his contract. During the payout period he has the contractual obligations of a regulated insurance company to pay him annuities for a specified period based upon actuarial computations which reflect mortality assumptions. Scholarship plans are not redeemable at any time during the accumulation period. The payouts which are received by the beneficiaries do not involve any actuarial assumptions or the assumption of any risk by the trust.

1/ Securities and Exchange Commission v. The Variable Annuity Life Insurance Company of America, 359 U.S. 65, 71 (1959).

2/ This is especially true since PacFund has not set any maximum family income level above which it will not sell plans. (Tr. 505; App. 20). Thus investors with very high income, who would not be subject to meaningful loss even if their student beneficiaries did attend college, will be able to buy plans, not as insurance but as speculation. Basic insurance principles would require that plans not be sold to investors with student beneficiaries who are almost certain to attend college.

More importantly, the variable annuity contract is reasonably related to the purposes for which it is sold, while scholarship plans are not so related. The variable annuity is intended to provide income for the retirement of the annuitant. The annuitant can expect to receive benefits that are related to the investment performance of the fund into which he has contributed his money. While the precise performance is not ascertainable, he can make an investment judgment with respect to the amount which he is likely to receive. On the other hand, a person buys a scholarship plan in order to defray the costs of his child's education. However, the investor can have absolutely no basis for formulating an investment judgment as to the amount he is likely to receive, since this amount is primarily based on the number of forfeitures by other planholders.

B. Features of the Plans.

The planholder loses his investment account if he fails to make agreed installment payments or if he withdraws any part of his savings account. In addition, the entire investment account is forfeited if the student-beneficiary fails to enter college or to continue beyond the first year. A forfeiture will also result if a student dies and a substitute is not named within 90 days. The investor will also forfeit if he fails to submit to PacFund any required report or if he fails to pay any charge when due (such as transfer and substitution charges). (App. Ex. 3, § 7; Tr. 422-425).

In the event of forfeiture, the planholder will lose his share of all savings account earnings which have been previously transferred to the Trustee Bank, together with earnings resulting from the reinvestment of these amounts while in the trust, plus any additional accretions equal to the planholder's share of amounts forfeited from other investment accounts. A planholder who forfeits the earnings in his investment account will also lose portions of his principal to the extent that he has paid nonrefundable taxes on earnings previously transferred to the investment account. (Tr. 549). In addition, a successful planholder can also lose portions of his investment account if the balance exceeds the "qualifying expenses" of the higher education of his child-beneficiary. (Tr. 666-669).

The record shows that the total amounts forfeited by planholders will be substantial. An investor in Plan A (a $20 per month plan) who completes his savings period would lose $818, or 32% of his total payments, if his child-beneficiary fails to attend college or to continue beyond the first year. (App. Ex. 9, pp. 14-15). This figure only includes sales load, administrative charges, and earnings actually transferred from a planholder's savings account. It does not include reinvestment earnings in the trust or further gains resulting from forfeitures of other accounts. Based on the projections prepared by Mr. Virga, which reflect these additional gains and earnings, total forfeitures could amount to as much as $1943.49, or 77% of total payments into Plan A. (Div. Ex. 5; Appendix II).

These forfeitures are more adverse to the investor's interest than the possible losses which would be incurred in a conventional front-end load contractual plan. In an ordinary periodic payment plan, an investor can hope to some extent to recoup his sales cost through appreciation in the value of his underlying investment. But a PacTrust planholder who forfeits his investment account can only receive the principal which was deposited in his savings account.1/ Applicant's forfeiture provisions also differ from forfeitures of sales load and administrative charges in that forfeited amounts are transferred to the accounts of other planholders. Thus Applicant's planholders actually "invest" in forfeitures and gamble upon the success of their own plans as compared to the results of other plans. The granting of Applicant's request for exemptions would amount to recognition by the Commission that investor forfeitures can be an appropriate form of investment in themselves.

Applicant has argued that forfeitures are a common incident of everyday living. (Br. 21). One of Applicant's expert witnesses, Dr. Wise, compared the plans to her teachers' retirement program, which provides for the forfeiture of the contributions of the school district and the state government in the event of a teacher's early retirement. (Tr. 202). Yet such a program differs fundamentally from Applicant's scholarship plans. Dr. Wise pays no sales load on her contributions, and, if she completes the program, her expected benefits are guaranteed notwithstanding the retirement experience of other teachers. (Tr. 219). In a scholarship plan, the amounts which successful beneficiaries will receive are directly influenced by the lapse experience

---

1/ Thus the Commission has stated, with respect to front-end loads charged on the sale of face-amount certificates: "Persons who purchase face-amount certificates and fail to complete most of the payments provided for cannot even hope - as can contractual plan investors - that rising security market levels will enable them to recoup the front-end load deductions." Securities and Exchange Commission, Report on the Public Policy Implications of Investment Company Growth ("Mutual Fund Report") House Report 2337, 89th Cong., 2d Sess. (December 2, 1966), p. 250.

of other plans. If a plan is successful, but if no other plans forfeit, the student beneficiary will only receive the compounded earnings on his investment account. In the case of an installment plan, the investor will have also paid $210 in sales load and administrative charges.

The fact that the planholders have a stake in the experience of other accounts distinguishes the plans from other formsof investment which involve potential forfeitures. Applicant relies upon this distinction to support its application for exemptions. It is argued that, unlike excessive sales loads, the forfeitures cannot contribute profits to the sponsor or servicing agent because lapsed account balances must always be transferred to remaining investors. (Br. 17). From the point of view of an investor in the plans, it makes little difference who received the forfeitures, since in any case, he loses his complete investment in the trust. Moreover, the distribution of forfeitures to remaining investors only serves to create further inequities.

Scholarship plans exhibit some of the abuses of which are inherent in the tontine insurance policies that are prohibited in Washington and many other jurisdictions.1/ In a tontine life insurance policy the payment of dividends on the policy is deferred for a period of time, usually ten

---

1/ The Washington statute provides:

> No life insurer shall hereafter issue for delivery or deliver in this state any life insurance policy
>
> (1) Issued under any plan for the segregation of policyholder into mathematical groups and providing benefits for a surviving policyholder of a group arising out of the death of another policyholder of such group, or under any other similar plan.
>
> (2) Providing benefits or values for surviving or continuing policyholders contingent upon the lapse or termination of the policies of other policyholders, whether by death or otherwise.

R.C.W.A. §48.23.340.

or fifteen years. Those policyholders who die forfeit their interest in the dividends, though not in the face amount of the policy. Those who lapse forfeit both dividends and cash value. The accumulated dividends and forfeitures of each class of policies are paid to those policyholders whose policies are still in force at the end of the period. In a semi-tontine policy, there are no forfeitures of cash values. The amount of the premium in excess of allocations for expenses, losses and legal reserves is not distributed as an annual dividend, but constitutes the source of the tontine which is paid to surviving policyholders at the end of the period.1/

Tontine policies have been outlawed in many jurisdictions, principally because of their likeness to gambling contracts and because of their high susceptibility to misrepresentation.2/ Applicant has endeavored to reduce the potential for misrepresentation by instructing salesmen to refrain from making any projections as to future benefits. Nevertheless, the very form of this investment gives rise, in the words of one commentator, to a "misleading appeal to the perpetual optimism in human nature." This is because the benefits of tontines will only be substantial if many investors forfeit, and an investment in a tontine by itself is likely to encourage persistence, and thereby result in fewer lapses.3/

Scholarship plans actually involve a much higher degree of speculation than tontine insurance policies. Tontine insurance policies retain their face values in the event of the policyholder's death; he is

---

1/ See Kimball and Hanson, The Regulation of Specialty Policies in Life Insurance, 62 Mich. L. Rev. 167, 184-185 (1963).

2/ Id. at 185-189.

3/ Id. at 193.

fully protected despite loss of dividends. By contrast, an investor who forfeits his scholarship plan prior to his child's entrance into college will lose the entire amount of his trust balance.

A Commission representative testifying at the Congressional hearing which led to the enactment of the Act recognized the tontine concept as it related to face-amount certificate companies:

> The sales overhead and maintenance costs on . . . face-amount certificate companies almost consumed entirely the dividends or revenues from the underlying portfolios; so that the only way in which these face-amount certificate companies can make good on their guarantees to pay the subscriber a fixed amount at the end of the period of investment is by realizing income from another source. The only other source conceivable is through lapses and defaults of a vast number of their subscribers.1/

The same witness criticized this arrangement in the following language:

> It is regrettable for any company to engage in a business which is predicated upon the primary assumption that a substantial number of people who invest in it, must lose all of most of their money.2/

In the face-amount certificate company, this abuse was eliminated through the requirement that such companies must maintain adequate reserves in order to meet their obligations under the certificates. In the case of periodic payment plan certificates, the same result is achieved by the requirement that such certificates must be redeemable.

1/ Testimony of John Boland, Attorney, S.E.C. General Counsel's Office, Senate Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency ("Senate Hearings"), 76th Cong., 3d Sess., 165-166. Scholarship plans also involve other abuses which were noted in the operation of face-amount certificate companies. Both forms of investment are marketed as "compulsory savings" toward a specific goal. The Commission noted that face-amount certificate companies frequently sold certificates on the basis of misleading comparisons to savings bank deposits and insurance companies. See S.E.C. Investment Trust Report, Supplement on Companies Issuing Face Amount Installment Certificates, 23.

2/ Senate Hearings 165.

The record reveals the manner in which Applicant's tontine plans must operate to the advantage of certain planholders and to the disadvantage of others. On the basis of a study of a random sampling of high school seniors graduating in 1965, Mr. Adams concluded that students in families with higher incomes would be more likely to attend college than students in lower income families; that males will be more likely to continue their education than females; and that the children of blue-collar workers would be less likely to go to college than students from white-collar families. (Tr. 575-584). The most important factor affecting the likelihood of college attendance is the parents' education. The higher the education of the parents, the more likely that their children will attend college. (Tr. 587-589). The study exhibited similar patterns in college dropout rates. (Tr. 589). Thus, the male children of wealthy college-educated parents would have much better chances of participating in the benefits of Applicant's plans.

Applicant has contended that its plans will be operated in such a manner as to avoid discrimination among planholders. In order to accomplish this objective, Applicant proposes to restrict the sale of its plans to investors whose annual family income exceeds $6,000. In addition, SICO's salesmen would be directed to consider certain other factors which bear on the likelihood that an investor will complete his plan and that his child will receive benefits. Such factors include the level of the parent's education and the physical and mental health of the child. Nevertheless, there are several important aspects of the plans which will tend to reduce the effect of these standards. Most importantly, as a result of the tontine structure of the plans, they must be sold under contradictory assumptions. On the one hand, salesmen will de directed to sell plans only to those investors who are unlikely to forfeit.1/ However, since the success of any one plan depends upon the failure of other plans, there will be a real temptation to sell plans to persons who are likely to forfeit. In addition, the plans will be subject to limited transfer by investors. Although this policy is intended to protect the investor who subsequently discovers that he will not be able to complete his plan, it also subverts Applicant's marketing policies to the extent that the transfer of a plan might bypass SICO's controls. Also, depending on the age of the child-beneficiary, it might be difficult for the parent or the salesman to assess the likelihood that a plan might reach maturity. If an investor purchased a plan for his one-year old child and subsequently discovered that the child would probably not be able to attend college, he would stand to forfeit the plan unless he had another child who could be substituted. (Tr. 595). Despite Applicant's intention to reduce inequities among its planholders, significant differences would still exist among planholders with respect to their likelihood of success.

When the tontine structure of Applicant's plans is coupled with the significant variations among plan investors, it is evident that Applicant

---

1/ Thus SICO's salesmen must comply with the suitability requirements set forth in Rule 15b10-3 under the Securities Exchange Act of 1934.:

> Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.

will discriminate in favor of certain planholders. Under scholarship plans, in effect, the money which is derived from the relatively higher rates of attrition among lower middle class children will subsidize the education of their wealthier peers.

Applicant's plans will also discriminate among planholders with respect to the allocation of forfeitures and earnings among trust fund accounts, and with respect to the payouts of benefits to successful student beneficiaries. Under the terms of the investment agreement, plan forfeitures will be allocated among the remaining investors solely on the basis of the amounts accumulated in each investor's investment account. Savings account balances will be disregarded for purposes of the allocation. (App.Ex. 3 §5.1). As Division's Exhibit 4 (Appendix I) demonstrates, those planholders who purchase plans for children who are still very young will complete their deposit periods early and will be able to leave their investment account balances in the trust until such time as their children enter college.1/ As a result of this additional period of investment, or any delays permitted by PacFund, the delaying investor's account will consume a disproportionately greater share of earnings and forfeitures. As previously noted, a student participating in Plan A who does not enter college until five years following the expiration of the savings period will gain 2 1/2 times the amount which would be received by a student in the same plan who enters college immediately following the expiration of his savings period. Where the delay is eight years, the total payouts would almost quadruple the gains of a plan which is completed

---

1/ The exhibit is based on the same forfeiture and dropout assumptions that are contained in Applicant's Exhibit 10, except that the Division's model assumes that continuous sales are made to only one plan type. (Tr. 693-694).

without any delay. In addition, those investors who enroll during the first few years of PacFund's operations would not be able to participate in the allocation of the larger forfeitures which result when students drop out of college.

The Applicant's proposed conditions will not correct these imbalances. (App. 43-45). Although heralded as the fairest method to investors, the "Dollar-Month Account" method described in condition 1(a) is both incomplete and illogical. It is incomplete because Applicant has not explained how the total dollar-months credited to an account would be calculated in the event of a delay. It is illogical because it assumes that one dollar left in the account for two years would be worth the same amount as two dollars left in the account for one year. If one dollar left in a savings account for two years were worth the same as two dollars left in an account for one year, the one dollar would be required to earn an effective interest rate of 100% during this period.

Condition 1(b) outlines the method of allocation which is currently used by The Trust Fund Sponsored by the Scholarship Club. Inc. (App.Ex. 27). This method appears to be primarily intended to prevent discrimination against plans which are purchased in the early years of the trust's operations.1/ It provides that pre-college earnings and forfeitures are distributed among all currently active plans, but that the larger college forfeitures would only be allocated among students in the same expected entry year as the beneficiary of the lapsed account. The difficulty with this approach is that it creates wide variations in payouts from year to

---

1/ File No. 811-1515-2, Notice of Special Meeting, dated October 4, 1971, at page 3.

year, depending on the experience of a particular class. There is also a possibility that a student could shift into a college entrance class of inferior students in order to improve his chances of obtaining increased forfeitures.

Finally, proposed condition 1(c), which was initially suggested by the staff (Tr. 701-703), does not completely correct the imbalances between plan trust accounts resulting from delays in students entering school after completion of their savings deposit requirements. Under this method, for example, a student in Plan A who delays entering college for five years would still receive $369 (comprised of earnings and forfeitures) more per year than a student who enters immediately following the end of his deposit period. (Div.Ex. 4).

Substantial differences in payouts can also occur as a result of Applicant's current policy of permitting more than one plan to be purchased for a single child. (Tr. 541). Student-beneficiaries of multiple plans will receive inordinately high portions of total forfeitures. Thus the plans favor well-to-do families who can afford to purchase more than one plan, and who will be more likely to receive the benefits of forfeitures.

Applicant's plans also discriminate among investors with respect to the proposed method of calculating payouts to successful students. Since a student can never receive more than his "qualifying expenses," it is likely that in many cases successful students will forfeit portions of their investment accounts. For example, Mr. Gill testified that the State of Washington encourages students to complete their education as quickly as possible, and in accordance with this policy, an extensive system of community college has developed. (Tr. 668). Since the average expenses of attending a community college are less than the cost of going to a four-year school, there is a strong probability that many students in two-year shcools would forfeit surplus amounts. (Tr. 670-673). Applicant recognized this result in its Student Payout Projections:

> There is a definite trend toward making higher education more flexible and efficient. So-called stop-outs (time a student simply elects not to go on to school; perhaps for a quarter, a year or several years) and shortened school programs (e.g. traditional four-year programs reduced to three) may become commonplace in the next five to fifteen years. Further, the two-year schools with their emphasis on terminal vocational and technical programs are growing much faster than their four-year counterparts. If these trends continue, they would have the effect of reducing the payout period for many PacFund student-recipients. This could increase the size of payouts to other remaining PacFund students. (App.Ex. 10, Note 1, page 4-5).

Students who commute to school or who attend school on a part-time basis might also qualify for benefits from Applicant's plans. (Tr. 663-664). Yet their expenses would probably be lower, and they would also be likely to forfeit sums to other investors. Thus the scholarship plans favor those students who will be more likely to use all or most of the amounts accumulated in their investment accounts. Students who attend a two-year community college, especially if they commute, will subsidize the educational expenses of students who travel across the country to a prestigious four-year school.

The problems which are inherent in scholarship plans are exhibited by the experience of The Trust Fund Sponsored by The Scholarship Club Inc., the only scholarship plan which has obtained from the Commission exemptive relief to enable it to operate lawfully under the Act. From the commencement of that plan's operations in 1969 through December 31, 1971, a total of 9,055 installment plans were sold. Of this number, 4,381 plan trust accounts, or 48.4% of the total number sold, were forfeited. During the same period 825 fully paid plans were sold. Of this number, 115 or 13.9% of the total number of such plans sold, were forfeited. Despite these high forfeiture rates, total forfeitures yielded only $97,015, exclusive of sales loads and administrative charges. Based on the 5,384 plans which were outstanding at December 31, 1971, the average forfeiture allocation to each such plan amounted to $18. In 1971, the first class of eligible students received payouts from the trust. Each of the three initial qualifying students received an average of $260 for the second year of college. (App.Ex. 27, pp. 16, 17, 25, 35).

The foregoing discussion demonstrates that, under the provisions of its periodic payment plans, the Applicant would, in the language of Section 1(b), ". . . issue securities containing inequitable or discriminatory provisions. . . ." Thus, it is clear that the instant proposal would not, within the language of Section 1(b), "mitigate and so far as is feasible, eliminate the conditions . . . which adversely affect the interest of investors," i.e., the issuance of "securities containing inequitable or discriminatory provisions." (Emphasis added) In fact, as indicated, the proposal would create the adverse condition. Thus, it cannot be found that the proposal would be "necessary or appropriate in the public interest and consistent with the purpose of investors and the purposes fairly intended by the policies and provisions of this title," within the meaning of Section 6(c).

III. Section 23(c) and Rule 23c-1

Although Applicant has not requested an exemption from Section 23(c) of the Act and Rule 23c-1 thereunder, it appears that such provisions would prevent the operation of the instant plans unless the Commission issues an appropriate order. Section 23(c) prohibits a registered closed-end investment company from purchasing its own securities other than on a securities exchange or pursuant to tenders, except under such circumstances as the Commission may permit by order or rules to ensure that such purchases are made in a manner or on a basis which does not unfairly discriminate against any holders of the class of securities to be purchased.1/ The terms of Applicant's plans provide for payments to qualifying student-beneficiaries. This involves a "purchase" by the Applicant of its own securities, within the meaning of Section 23(c). Since such purchases are not to be made on an exchange or pursuant to tenders, the proposed purchases are prohibited unless made pursuant to the terms of the rule, or unless the Commission issues an order under Section 23(c)(3). The proposed purchases will unfairly discriminate against those planholders who are not given the same opportunity to have their interests purchased as is accorded to qualifying students at any given time. The discrimination is accentuated here, since the investor who is not given the opportunity to sell may be forced by circumstances to forfeit his interest thereafter. Consequently, the proposed purchases do not comply with the rule, and the Commission cannot issue an order under

---

1/ Pursuant to this section, the Commission adopted Rule 23c-1, which provides in part, that "a registered closed-end company may purchase for cash a security of which it is the issuer subject to the following conditions: . . . (9) the purchase is not made in a manner or on a basis which discriminates unfairly against any holders of the class of securities purchased."

Section 23(c)(3). In view of the repurchase terms of its plans, Applicant would, in the language of Section 1(b), ". . . issue securities containing inequitable or discriminatory provisions . . . ." Therefore, the Commission should not grant an exemption from Section 23(c) pursuant to Section 6(c). It is recognized that under the plans, purchases will not commence for at least eight years. However, Applicant may not presently issue a security providing for its subsequent purchase by the issuer, where the terms specifying the manner for effectuating the purchase would operate to prevent the issuance of a prior Commission order required to permit the purchase.

IV. Section 23(b)

Section 23(b) of the Act in general prohibits a closed-end investment company from selling its shares below current net asset value. The purpose of the section is to prevent dilution of the financial interests of the persons entitled to participate in an enterprise. As the Commission observed in Trust Fund Sponsored by the Scholarship Club, Inc., it is difficult to calculate current net asset value because of the inherent nature of the plans.1/ In connection with the requested exemption, the Applicant itself has stated that there is no means of ascertaining the extent of future gains which may be acquired through forfeitures, or the number of persons who will be entitled to participate in the assets of the trust. (Br. 35).

Applicant is not entitled to an exemption from these provisions merely because its program is structured so that it cannot comply with the section. The inability to compute net asset value is yet another example of the inequities which arise out of these tontine plans. An exemption should not

---

1/ Investment Company Act Release No. 5524, pp. 9-10.

be granted unless Applicant can demonstrate that the plans satisfy the provisions of Section 6(c). Applicant has not only failed to demonstrate compliance with this section, but the facts reveal that the plans involve forfeitures and other inequities which are inconsistent with the standards of Section 1(b). Hence the application for exemption from Section 23(b) pursuant to Section 6(c) should be denied.

Applicant has requested temporary relief from Section 23(b) until such time as it can attempt to obtain the consent of a majority of its planholders in accordance with the exception set forth in Section 23(b)(2). (Br. 36). However, the peculiar structure of the plans renders it impossible for Applicant to obtain this necessary consent. The section provides for sales below net asset value if the persons who hold the financial interests in the enterprise consent to a dilution of their interests. Under Applicant's plans, the beneficial financial interests rest only in the child-beneficiaries of the trust, and it is impossible to determine the number and identity of those who will be entitled to participate. Thus no purpose would be served by granting a temporaty exemption since the plans can never satisfy the provisions of Section 23(b)(2).

V. Section 18(i)

Section 18(i) requires that each share of stock issued by a registered management company must have equal voting rights with every other outstanding voting stock. Since scholarship plans will differ in their share of the trust at any point in time, Applicant's proposal to give one vote to each plan will frustrate the objectives of Section 18(i). All planholders would exercise the same voice in the operations of the trust despite the differing proportionate interests which they would hold. Thus Applicant's method of assigning voting rights continues the pattern of discrimination which is exhibited elsewhere in the plans' operations.

The underlying purpose of Section 18(i) is to assure shareholders a measure of control over their management. Without compliance with this section the planholders would not only be deprived of their proper proportionate voting rights in trust affairs, but would also be denied the proportionate voting rights which the Act specifically confers on holders of voting securities.1/ Section 13(a) requires approval by the vote of a majority of the outstanding voting securities of a registered company prior to any change in (1) its investment policies or (2) its business so as to cease to be an investment company. Section 16(a) prohibits any person from acting as a director of a registered investment company unless elected by the holders of the outstanding voting securities at a meeting called for that purpose. Section 32(a)(2) and 32(a)(3) provide, respectively, that the holders of a majority of the outstanding voting securities of a registered investment company shall (1) ratify the selection of such company's public accountants, and (2) have the power to terminate the employment of such accountants. As an example of the importance of exercising proportionate voting rights in the operation of Applicant, Applicant's planholders could exercise their disproportionate vote to alter the method of allocation of forfeitures and earnings.2/

Applicant has attempted to justify its method of assigning voting rights on the grounds that the plans are designed so that the total amounts which will be "transferred to Applicant and the opportunity to derive benefits from Applicant under each plan type will be substantially equal." (Br. 33).

1/ Savings Bank Investment Fund, 24 S.E.C. 531-536 (December 17, 1946). Insured Accounts Fund, 39 S.E.C. 123 (1957).

2/ A change in the distribution system was effected by shareholder vote in the Trust Fund Sponsored by The Scholarship Club, Inc. File No. 811-1515-2. Notice of Special Meeting, dated October 4, 1971.

This statement speaks as of the time of completion of each plan's pay-in period. However, since plans will be commencing at different times, the amounts of the capital investments of the planholders, including accretions thereon, will vary widely at any given time. Thus, under the proposed voting procedure, all investors will have the same voting power regardless of the differences in their proprietary interests in the enterprise.

It is therefore apparent that under the provisions of the plans, the control of Applicant, in the language of Section 1(b), ". . . is inequitably distributed." It is clear that the proposal would not, within the language of Section 1(b), "mitigate and, so far as is feasible, eliminate the conditions . . . which adversely affect . . . the interest of investors," i.e., "inequitably distributed" control of investment companies. (Emphasis added). In fact, the provisions of the plans have the opposite effect. Therefore, the Commission should not grant an exemption from Section 18(i) pursuant to Section 6(c).

VI. Section 14(a)

Section 14(a) prohibits a registered investment company from making a public offering of its securities unless such company has a net worth of at lease $100,000.1/ The section was intended to prevent poorly capitalized companies from selling their shares to the public, and to ensure that there is a sufficient sized staff to provide satisfactory levels of investment skill.2/

1/ Contrary to Applicant's assumptions, an exemption from this section was not requested by or granted to The Trust Fund Sponsored by the Scholarship Club, Inc. (Investment Company Act Release No. 5524). It appears that such plan did not require the exemption because it met the net worth requirement as a result of the fact that it had been in operation for several years before it filed an application with the Commission.

In the case of The Trust Sponsored by the Episcopal School Foundation College Award Program, Inc., the Hearing Examiner's Initial Decision denied the request for an exemption from Section 14(a). File No. 3-1374 (October 24, 1968).

2/ Mutual Fund Report, pp. 251-252.

Applicant contends that the structure of scholarship plans does not lend itself easily to the Act's net worth requirements, since, with certain exceptions, all amounts deposited and invested in the trust must be used to meet the educational expenses of the investors' child-beneficiaries. Applicant has represented that its promoters do not have enough children in order to meet the $100,000 minimum requirement, and has urged that the Commission apply the net worth test to SICO, which is charged with the responsibility of administering the trust, and which has assumed the obligation of paying for expenses of the trust. (Br. 29-30; App.Ex. 13). However, Section 14(a) applies the net capital requirement to the investment company and not to its sponsor. Accordingly, there is no statutory basis for applying this test to SICO. Moreover, SICO is an independent contractor, and is not legally obligated to render services exclusively to the trust fund. SICO's charter permits it to service other similar funds and to engage in other businesses, and there is evidence that it is currently conducting training classes for prospective securities salesmen. (Tr. 565-566). Should this business prove profitable, or should another scholarship trust be organized and attract SICO's management, there would be nothing to prevent SICO from finding some means of abandoning its relationship with Applicant. Thus SICO's assets are not exclusively available for use by the investment company in the same manner as its own assets.

Applicant has also urged that the Commission consider the $50,000 which will be deposited in its Reserve Trust before plan sales may commence. This amount should not be included in PacTrust's assets for the purposes of Section 14(a), since it can only be used for "unanticipated extraordinary expenses of

PacFund or to remedy any defaults in SICO's performance under the Service and Investment Agreements." (App.Ex. 5, 7, 9, 24). Even then, PacFund can only draw on these assets if it receives the consent of the state securities administrator. In addition, those amounts which will accumulate as a result of future plan sales cannot be included in the net worth calculation, since they will not be available to PacFund prior to the commencement of its sales. Even if the $50,000 is considered an asset for the purpose of Section 14(a), the trust will still not meet the $100,000 net worth requirement.

Finally, Applicant has urged that the Commission take into consideration the business and professional experience of the directors of SICO and PacFund.1/ Although such factors are not relevant to the Act's net worth requirements, it is noted that these individuals have had no previous securities experience and their professional careers have been oriented primarily toward education and labor relations, which are fields that have little bearing on Applicant's everyday operations as an investment company. (App.Ex. 1; Tr. 11-20).

In view of the requirement that the Section 14(a) test be applied to the investment company, and not to SICO, and the fact that the investment company has no assets, the granting of an exemption from Section 14(a) would nullify the protection of the Act, and adversly affect the interests of investors contrary to the purposes enunciated in Section 1(b)(8), by permitting Applicant to operate "without adequate assets or reserves."

1/ An examination made of the Commission's files in the light of Applicant's position reveals that the Commission has recently ordered public proceedings under the Securities Exchange Act of 1934 involving a director and principal stockholder of SICO. (Securities Exchange Act Release No. 9811 (September 27, 1972).

VII. Other Considerations

A. Disclosure.

In The Trust Fund Sponsored by the Scholarship Club, Inc., the Commission granted to a Florida scholarship trust similar exemptions to those which Applicant currently requests.1/ In granting these exemptions, the Commission summarized various arguments which were advanced by the Division in opposition to the application, and stated:

> The Division has raised serious questions about the merits of applicant's plans. We have not, in considering the present application, undertaken to determine whether or not the applicant's proposed operation is a good way for parents to provide for the college education of their children. As noted by the applicant, we shall have jurisdiction to consider the adequacy and accuracy of the disclosures to be made in the Securities Act prospectus and in sales literature to be used by the Sponsor. We are not prepared to assume, in advance, that it will not be possible to arrive at a proper presentation, in the prospectus and sales literature as well as in the terminology of the plan agreements, which will give adequate, accurate and explicit information, fairly presented, as to the nature of the plans.2/

The Commission should overrule its decision in The Trust Fund Sponsored by The Scholarship Club, Inc. The foregoing discussion demonstrates that, without considering their merits, scholarship plans thwart the purposes of the sections from which exemption is sought. In addition, these plans present insurmountable problems of disclosure. As the Commission stated in The Variable Annuity Life Insurance Company of America, disclosure should be made "in keeping with the objectives of Section 1(b)(1) of the Act, that investors receive "adequate, accurate and explicit information, fairly presented," concerning the character of the securities in which they are asked to invest."3/ Applicant contends that its plans will be fully disclosed to planholders through the prospectus and other periodic reports which will

---

1/ Investment Company Act Release No. 5524 (October 25, 1968).

2/ Id. at p. 6.

3/ 39 S.E.C. 680, 704 (1960).

contain "investor and student statistics, and related matters." (Br. 39). As shown below, scholarship plans cannot be meaningfully disclosed.

The basic policy underlying disclosure is that those who make use of the public's money must supply the information essential to the formulation of intelligent investment decisions.1/ This standard reaches beyond the need to disclose that a particular security involves speculative risks, or that the investor should be aware of certain features in the operation of a company. The investor should also be supplied with sufficient information in order to enable him to measure the extent of his risk.

In the case of investment companies, full disclosure includes more than an accurate description of the company itself.2/ Management investment companies are also required to supply additional detailed information concerning the particular securities which make up their portfolios.3/ In this way, investors are able to get an accurate picture of the company's activities by going beyond its fundamental policies and restrictions, and by examining the operations and earnings of the portfolio companies.

There is an obvious need for similar disclosure to purchasers of scholarship plans. Applicant has recognized this need in the case of disclosures relevant to its municipal bond portfolio. Because of the tontine structure of the plans, the planholder's expectations of gain are principally

---

1/ S.E.C., Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts ("The Wheat Report"), p. 46.

2/ The Commission's recently published guidelines for the preparation of management investment company prospectuses devote considerable attention to portfolio policy and other disclosures relating to the securities in which the Company invests. Investment Company Act Release No. 7220 (July 9, 1972).

3/ Regulation S-X under The Securities Act of 1933, The Securities Exchange Act of 1934 and The Investment Company Act of 1940, Rule 6.10 (d) and Rule 12.19.

tied to anticipated forfeitures of unsuccessful plans. However, Applicant cannot forecast future trends in forfeitures, and historical information of this kind is not meaningful. In order to make even an informed guess, let alone an investment judgment, a prospective planholder would also need detailed information concerning the income and educational background of present and future planholders, as well as information as to the health, competence and attitudes of present and future student-beneficiaries. Much of this kind of information cannot be obtained. Consequently, meaningful disclosure of this type of gamble is impossible. Putting money into one of the scholarship plans is almost like betting on one horse in a race without knowing what other horses are running.

The overall effect of disclosure must also be considered in the context of the proposed method of distribution of earnings and forfeitures. For example, if Applicant follows its current allocation formula, large amounts of earnings and forfeitures would not accrue to surviving installment plans until relatively late in the life of those plans. Accordingly, any current data concerning forfeitures and payout experience during the early stages of the plans would not be relevant to future results. In the case of Applicant's proposed condition 1(b), current data would be even less relevant since, as previously noted, this method of allocating forfeitures would result in wide variations of payouts from year to year.

Thus, the information which is most important to the plans cannot be disclosed, and the only information which can be disclosed will probably be misleading. In the earlier scholarship case, the Commission stated that "the critical requirement here . . . is that of a full disclosure of the features of the plans with respect to the forfeiture provisions and their consequences."1/ The legislative history of the Act demonstrates the inadequacy of disclosure as an exclusive remedy to correct the abuses of the industry. As Commissioner Healy stated:

> "Because of the peculiar character of investment companies and their resemblance to savings banks, mere disclosure is inadequate as a remedy. . . The disclosure principle embodied in the Securities Act and Securities Exchange Act is a sound principle, but it has its limitations." _/

B. The Public Interest Standard.

Even if the Commission should conclude that the proposal is "consistent with ... the purposes fairly intended by the policy and provisions" of the Act, an exemption cannot be granted under Section 6(c) unless the Commission also finds "that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors ..." It is a fundamental rule of statutory construction that effect shall be given to every word.3/ Neither courts nor administrative agencies are free to construe any statute so as to deny effect to any part of its language thereby making such part superflouous or insignificant.4/ Thus, where Congress has seen fit to set forth various standards in Section 6(c), compliance with each of the standards is required.

1/ Investment Company Act Release No. 5524, p. 9.

2/ Senate Hearings, pp. 38-39.

3/ In Market Company v. Hoffman, 101 U.S. 112, 115 (1879), the Supreme Court stated:
> "It is a cardinal rule of statutory construction that significance and effect shall, if possible, be accorded to every word."

See also, United States v. Campos-Serrano, 404 U.S. 293, 301 (1971).

4/ Ibid. The Court stated that "We are not at liberty to construe any statute so as to deny effect to any part of its language." 101 U.S. at 115.

In determining whether the plans are necessary or appropriate in the public interest and consistent with the protection of investors, consideration should be given to the product proposed to be sold. These plans, to a large extent, involve an "investment" in forfeitures and, in this respect, no participant gains unless others lose. Instead of sharing a common objective of profiting proportionately from the enterprise, the participants are pitted against each other.

These plans resemble insurance and involve investment aspects, but the real expectation of gain relates to gambling. Unlike a pure lottery, however, the participants are not given an even chance. Through its choice of purchasers, the underwriter can largely influence the extent of forfeitures, and thereby improve the level of benefits to the class most likely to succeed. Disclosure cannot eliminate these characteristics of the plans, which in their totality are inimical to the interests of investors.

Applicant contends that its plans "meet the public need for and interest in higher education in the United States by serving as an additional source of needed private financing for student costs of higher education." (Br. 49). Education is a worthwhile objective, but it does not justify the granting of exemptions which would permit the operation of an inequitable program of this kind.

VIII. Conclusion

For the foregoing reasons, the application should be denied.

Respectfully submitted,

William H. Kleh

WILLIAM H. KLEH, Attorney

Counsel for the Division of
Investment Company Regulation

On the Brief

HAROLD SWEETWOOD, Special Counsel

Division of Investment
Company Regulation

November 10, 1972

APPENDIX

Explanation of Tables.

Appendix I includes portions of Division's Exhibit 4, entitled "Pacific Scholarship Trust Model of Plan A (and Plan D) Including a Delay in Entering College." The tables, which were prepared by Mr. Virga, show how the Applicant's allocation formula allows an investor to triple or quadruple the size of the scholarship payout to the plan's student-beneficiary as a result of delays after the end of the plan's normal accumulation period. Such a delay could be accomplished by purchasing a plan for a beneficiary while he was still very young, or by the beneficiary taking advantage of permissible delays such as military service. (App.Ex. 3, 88).

The calculations demonstrate that the amounts which are transferred to the investment account would need to grow at an annual compounded rate of 17.6% in order to provide a scholarship of approximately $750 per year. (Applicant's projected payout contained in its Exhibit 10). If a plan beneficiary delayed his entrance into college, his investment account would continue to grow at the compounded rate of 17.6% per year for each year of delay. In the case of Plan A, Appendix I shows that an eight-year delay would result in an annual payout of $2,678.34, as compared to a payout of $732.16 per year in the case of a plan which experiences no delays. The tables demonstrate similar results in the case of Plan D, a fully paid plan.

Appendix II, which contains Division's Exhibit 5, entitled "Pacific Scholarship Trust-Model of Plan A (and D)," was also prepared by Mr. Virga. The tables show the experience of a group of 10,000 investors in the plans who forfeit at the same assumed rates contained in Applicant's projections in its Exhibit 10.1/ Appendix II compares investments in Applicant's plans with similar deposits into a 4% savings account over the same period of time. The difference between an investment in Applicant's plan and the results of a savings account is shown in column 11 of the chart. This column gives the total losses due to sales load and lost interest in the case of a plan investor who withdraws at the end of any year. Thus, an investor whose child "withdraws" at the end of his senior year of college (i.e., completes the plan) will have earned $1,196 more than he would have earned from a savings account. The investor whose child completes only three years of college will have earned only $431 more than a comparable investment in a savings account. All other investors (66% of the total) would earn less than they would gain from a savings account. In the case of a forfeiture after the beneficiary's freshman

---

1/ In the case of an installment plan (Plan A), Exhibit 10 assumes termination rates of 7% and 5% for the first two years of the plan, and 3% for the third year and all following years. For a fully paid plan such as Plan D, the exhibit assumes a termination rate of 3% throughout all years of the plan's accumulation period.

In the case of all plans, it is assumed that the beneficiaries will finish high school. Thereafter, the exhibit assumes that 20% of the students will fail to enter higher education, and that 20% of the remaining students will drop out in each successive year of the four-year term.

year of college, the planholder would have $1,103 less than he would from a savings account.

Column 12 shows the percentage of original investors who gain or lose the corresponding amounts in column 11. Thus 10.75% of the original investors will lose $1,103 from a plan investment.

PACIFIC SCHOLARSHIP TRUST
MODEL OF PLAN A INCLUDING A DELAY
IN ENTERING COLLEGE

APPENDIX I- DIVISION'S EXHIBIT 4

YEAR	(1) TOTAL PRINCIPAL IN SAVINGS ACCOUNT	(2) ANNUAL TRANSFER TO (FROM) INVESTMENT ACCOUNT (.05) x (1)	(3) BALANCE IN INVESTMENT ACCOUNT (17.6 % Interest)
1	170.50	0	0
2	344.50	$ 8.52	$ 8.52
3	530.50	17.22	27.25
4	766	26.50	58.55
5	1,007	38.30	107.15
6	1,238	50.10	176.11
7	1,474	61.90	269.00
8	1,710	73.70	390.05
9	1,950	85.50	544.20
10	2,190	97.50	737.48
11	2,310	109.50	976.77
12	2,310	115.50	1,264.18
13 (Freshman)	0	115.50	1,602.18
14 (Sophomore)	0	(732.16)*	1,152.00
15 (Junior)	0	(732.16)*	622.60
16 (Senior)	0	(732.16)*	0

*ANNUAL SCHOLARSHIP AMOUNT

YEAR	(4) TRANSFER TO (FROM) INVESTMENT ACCOUNT	(5) BALANCE IN INVESTMENT ACCOUNT (17.6 % Interest)
FIVE YEAR DELAY		
18 (Fresh.)	0	$ 3,603.69
19 (Soph.)	$ (1,646.81)*	2,591.13
20 (Junior)	(1,646.81)*	1,400.36
21 (Senior)	(1,646.81)*	0
EIGHT YEAR DELAY		
21 (Fresh.)	0	5,860.97
22 (Soph.)	$ (2,678.34)*	4,214.16
23 (Junior)	(2,678.34)*	2,277.51
24 (Senior)	(2,678.34)*	0

*ANNUAL SCHOLARSHIP AMOUNT

METHOD OF ALLOCATING INTEREST AND FORFEITURES

$$\left[\text{AMOUNT IN EACH INVESTOR'S INVESTMENT ACCOUNT AT BEGINNING OF THE YEAR}\right] \times \frac{\left[\text{INTEREST ON ALL INVESTORS' INVESTMENT ACCOUNTS FOR THE YEAR PLUS ALL AMOUNTS FORFEITED DURING THE YEAR}\right]}{\left[\text{TOTAL AMOUNT IN ALL INVESTORS' INVESTMENT ACCOUNTS AT THE BEGINNING OF THE YEAR}\right]} \text{ EQUALS } \left[\text{INCREASE FOR THE YEAR IN EACH INVESTOR'S INVESTMENT ACCOUNT DUE TO INTEREST AND FORFEITURES.}\right]$$

PACIFIC S
MODEL OF
IN E

YEAR	E SA
1	
2	
3	
4	
5	
6	
7	
8	
9	
9.5	
10.5 (Freshman)	
11.5 (Sophomore)	
12.5 (Junior)	
13.5 (Senior)	

AR

DUE

PACIFIC SCHOLARSHIP TRUST
MODEL OF PLAN D INCLUDING A DELAY IN ENTERING COLLEGE

YEAR	(6) PRINCIPAL IN SAVINGS ACCOUNT	(7) ANNUAL TRANSFER TO (FROM) INVESTMENT ACCOUNT (.05) x (6)	(8) BALANCE IN INVESTMENT ACCOUNT (17.6 % INTEREST)
1	$ 1,600	0	0
2	1,600	$ 80	$ 80
3	1,600	80	174.08
4	1,600	80	284.72
5	1,600	80	414.83
6	1,600	80	567.84
7	1,600	80	747.78
8	1,600	80	959.39
9	1,600	80	1,208.24
9.5	1,600	40	1,354.57
10.5 (Freshman)	0	80	1,672.97
11.5 (Sophomore)	0	(764.51)*	1,202.90
12.5 (Junior)	0	(764.51)*	650.10
13.5 (Senior)	0	(764.51)*	0

* ANNUAL SCHOLARSHIP AMOUNT

YEAR	(9) ANNUAL TRANSFER TO (FROM) INVESTMENT ACCOUNT	(10) BALANCE IN INVESTMENT ACCOUNT (17.6 %)
FIVE YEAR DELAY		
15.5 (Freshman)	0	$ 3,582.98
16.5 (Sophomore)	$ (1,637.35)*	2,576.23
17.5 (Junior)	(1,637.35)*	1,392.30
18.5 (Senior)	(1,637.35)*	0
EIGHT YEAR DELAY		
18.5 (Freshman)	0	5,827.29
19.5 (Sophomore)	(2,662.95)*	4,189.94
20.5 (Junior)	(2,662.95)*	2,264.42
21.5 (Senior)	(2,662.95)*	0

* ANNUAL SCHOLARSHIP AMOUNT

METHOD OF ALLOCATING INTEREST AND FORFEITURES

$$\left[\text{AMOUNT IN EACH INVESTOR'S INVESTMENT ACCOUNT AT BEGINNING OF THE YEAR}\right] \times \frac{\left[\text{INTEREST ON ALL INVESTORS' INVESTMENT ACCOUNTS FOR THE YEAR PLUS ALL AMOUNTS FORFEITED DURING THE YEAR}\right]}{\left[\text{TOTAL AMOUNT IN ALL INVESTORS' INVESTMENT ACCOUNTS AT THE BEGINNING OF THE YEAR}\right]} \text{ EQUALS } \left[\text{INCREASE FOR THE YEAR IN EACH INVESTOR'S INVESTMENT ACCOUNT DUE TO INTEREST AND FORFEITURES.}\right]$$

YEAR	(1) NUMBER OF INVESTORS	(2) NUMBER OF WITHDRAWALS (A)	(3) ANNUAL PAYMENT (WITHDRAWAL) (B)	(4) PRINCIPAL IN EACH ACCOUNT (C)	(5) TOTAL PAYMENT (WITHDRAWAL) (1) x (3) (B)	(6) ADDITIONAL WITHDRAWALS (2) x (4) (A)	(7) NET TOTAL PAYMENT (5) - (6) (B)	(8) PAYMENTS (7) ACCUMULATED AT 5 % (C)	(9) PAYMENTS (WITHDRAWALS) (INCL. LOAD) (B)	(10) PAYMENTS (9) ACCUMULATED AT 4 % (C)	(11) GAIN (LOSS) DUE TO WITHDRAWING (10) - (4)	(12) % OF ORIGINAL INVESTORS WITHDRAWING	(13) TOTAL GAIN (LOSS) FROM WITHDRAWING (11) x (2) (H)
1	10,000	0	$ 170.50	$ 0	$ 1,705,000	$ 0	$ 1,705,000	$ 0	$ 240	$ 0	$ 0	0	$ 0
2	9,300	700	174	170.50	1,618,200	119,350	1,498,850	1,790,250	240	249.60	(79.10)	7.00 %	(55,370)
3	8,835	465	185.50	344.50	1,638,892	160,192	1,478,700	3,453,555	240	509.18	(164.68)	4.65 %	(76,576)
4	8,570	265	236	530	2,022,520	140,450	1,882,070	5,178,868	240	779.15	(249.15)	2.65 %	(66,025)
5	8,313	257	236	766	1,961,868	196,862	1,765,006	7,413,985	240	1,059.92	(293.92)	2.57 %	(75,537)
6	8,063	250	236	1,002	1,902,868	250,500	1,652,368	9,637,940	240	1,351.91	(349.91)	2.5 %	(87,477)
7	7,822	241	236	1,238	1,845,992	298,358	1,547,634	11,854,824	240	1,655.59	(417.59)	2.41 %	(100,639)
8	7,587	235	236	1,474	1,790,532	346,390	1,444,142	14,072,580	240	1,971.41	(497.41)	2.35 %	(116,891)
9	7,359	228	240	1,710	1,766,160	389,880	1,376,280	16,292,559	240	2,299.87	(589.87)	2.28 %	(134,490)
10	7,139	220	240	1,950	1,713,360	429,000	1,284,360	18,552,280	240	2,641.47	(691.47)	2.2 %	(152,123)
11	6,924	215	120	2,190	830,880	470,850	360,030	20,828,473	120	2,996.72	(806.72)	2.15 %	(173,445)
12	6,717	207	0	2,310	0	478,170	(478,170)	22,247,928	0	3,241.39	(931.39)	2.07 %	(192,798)
13 (Fresh.)	5,374	1,343	(2,310)	2,310	(12,413,940)	3,102,330	(15,516,270)	22,858,246	(2,310)	3,371.05	(1,061.05)	13.43 %	(1,424,990)
14 (Soph.)	4,299	1,075	(765.59)(D)	0	(3,291,265)	0	(3,291,265)	7,709,075	0	1,103.49	(1,103.49)	10.75 %	(1,186,252)
15 (Junior)	3,439	860	(765.59)(D)	0	(2,632,859)	0	(2,632,859)	4,638,700	0	1,147.63	(351.42)(E)	8.6 %	(302,221)
16 (Senior)	2,751	688	(765.59)(D)	0	(2,106,134)	0	(2,106,134)	2,106,134	0	1,193.53	430.74 (F)	6.88 %	296,349
		2,751									1,196.34 (G)	27.51 %	3,291,131
		10,000										100.00 %	

NOTES

A - Assume withdrawals occur at year end. Thus withdrawals during year 1 are shown at the beginning of year 2.
B - Assume payments take place at beginning of year.
C - Shows the amount in the account at year end, before any withdrawals or deposits made at this time.
D - \$765.59 is the annual scholarship amount.
E - (\$765.59 - \$1,103.49) x 1.04.
F - (\$765.59 - \$351.42) x 1.04.
G - [(\$765.59)(1.04)^2 plus (\$765.59)(1.04) plus \$765.59] - \$1,193.53.
H - Present value at year 1 of all gains (at 4% interest) equals \$1,921,713; Present value of all losses equals \$2,712,131.

PACIFIC SCHOLARSHIP TRUST - MODEL OF PLAN D

YEAR	(1) NUMBER OF INVESTORS	(2) NUMBER OF WITHDRAWALS (A)	(3) TOTAL PRINCIPAL WITHDRAWN $1,600 x (2)	(4) ($1,600 x 10,000) - COL. (3) ACCUMULATED AT 5%	(5) $1,796.50 ACCUMULATED AT 4 %	(6) GAIN (LOSS) DUE TO WITHDRAWAL (5) - $1,600	(7) % OF ORIGINAL INVESTORS WITHDRAWING ANNUALLY	(8) TOTAL GAIN (LOSS) FROM WITHDRAWING (2) x (6) (H)
1	10,000	0	$ 0	$16,000,000	$ 1,796.50	0	0	0
2	9,700	300	480,000	16,320,000	1,868.36	$ (268.36)	3.00 %	$ (80,508)
3	9,409	291	465,600	16,670,400	1,943.09	(343.09)	2.91 %	(99,839)
4	9,127	282	451,200	17,052,720	2,020.82	(420.82)	2.82 %	(118,671)
5	8,853	274	438,400	17,466,956	2,101.65	(501.65)	2.74 %	(137,452)
6	8,587	266	425,600	17,912,704	2,185.72	(585.72)	2.66 %	(155,802)
7	8,330	257	411,200	18,399,239	2,273.15	(673.15)	2.57 %	(173,000)
8	8,080	250	400,000	18,919,201	2,364.07	(764.07)	2.50 %	(191,017)
9	7,837	243	388,800	19,476,361	2,458.63	(858.63)	2.43 %	(208,647)
10 (Half Year)	7,602	235	376,000	20,074,179	2,556.98	(956.98)	2.35 %	(224,890)
11 (Freshman)	6,082	1,520	12,163,200 (B)	8,412,834	1,008.12 (D)	(1,008.12)	15.20 %	(1,532,342)
12 (Sophomore)	4,865	1,217	3,770,996 (C)	8,833,475	1,048.44	(1,048.44)	12.17 %	(1,275,951)
13 (Junior)	3,892	973	3,016,797 (C)	5,315,603	1,090.38	(284.74) (E)	9.73 %	(276,566)
14 (Senior)	3,114	778	2,413,747 (C)	2,413,747	1,134.00	510.53 (F)	7.78 %	397,192
		3,114				1,285.65 (G)	31.14 %	4,003,514
		10,000					100.00 %	

NOTES

A - It is assumed that withdrawals occur at year end. Thus withdrawals during year 1 are shown at the beginning of year 2.
B - (6,082 plus 1,520) x $1,600.
C - Annual amount of each scholarship ($775.13) x COL. 1.
D - $1,600 is withdrawn at beginning of 11th year.
E - ($775.13 - $1,048.44) x 1.04.
F - ($775.13 - $ 284.24) x 1.04.
G - [($775.13)(1.04)^2 plus ($775.13) x 1.04 plus $775.13] - $1,134.00.
H - Present value at year 1 of all gains (at 4 % interest) equals $2,550,473; Present value of all losses $3,149,883.

CERTIFICATE OF SERVICE

I hereby certify that on November 10, 1972, a copy of the foregoing proposed Findings of Fact and Conclusions of Law and Brief in Support Thereof on Behalf of the Division of Investment Company Regulation was served by mailing a copy of the same, by first class mail, to the following:

Pacific Scholarship Trust Sponsored by
The Pacific Scholarship Fund
By Lane, Powell, Moss & Miller,
1700 Washington Building
Seattle, Washington 98101
Attention: Hartley Paul, Esquire

William H. Kleh

William H. Kleh, Attorney
Division of Investment Company
Regulation