

III. CONTRACTUAL PLANS (FRONT-END LOAD ARRANGEMENTS)

(Section 16 of the Investment Company Amendments of 1967, amending Section 27(a) of the Investment Company Act of 1940)

The SEC proposes an amendment which would make unlawful the front-end load feature of certain contractual plans for buying mutual fund shares. Needless to say, this does not interfere with the established and sound practice of purchasing mutual fund shares over a more or less lengthy "contract" period, so long as the sales load is distributed evenly over all payments. This proposal is less radical than it appears at first blush since it does not interfere with sales on a "level-load" basis, and since the existing Act already partly regulates front-end load plans by forbidding deduction of more than 50% of the aggregate payments for the first year. However, this proposal has met heavy resistance from the industry because it would abolish a rather strong incentive to sell funds and collect an unusually large commission at the outset. I concur with the proposal to amend the Act to eliminate the front-end load feature.

1. I believe that an overwhelming case has been made out, both by the Wharton School Report and the SEC Study, for this proposal. Evidence shows the extent to which many mutual funds purchasers fail to complete their payments, and that most defaults occur within two or three years of initiating the contract, so that a disproportionate amount of money paid by the purchaser never is invested for him. Even if a contract plan is carried to completion, mathematically it is impossible for the investor to have working for him (on a front-end load plan) the same amount which would have been working for him over the same time period (on a level-load plan). See the statistics in the SEC Study at page 235. Full disclosure of all facts pertinent to the front-end load plan does not afford adequate protection because of (1) the difficulty of many investors in understanding the plan, (2) their failure to realize, when contemplating a default on payments, the consequences of the default; and (3) the fact that salesmen have such a strong economic incentive to push front-end load plans that they are unlikely to indicate the advantages of a level-load plan. Since the Investment Company Act, unlike the Securities Act of 1933, does not predicate its regulation solely upon a disclosure philosophy but has incorporated substantive safeguards, I believe it would be consistent with the Act's premises to extend this needed protection to unwary investors. More particularly, I believe that the front-end load plan imposes upon such investors a heavy and substantial risk of loss on top of all normal investment risks; and that since this is most likely to happen to investors least able to bear the risk of loss, it should be outlawed.

2. I address myself to several misconceptions promoted by industry sources concerning front-end load funds:

(A) The front-end load plan is chiefly defended on the ground that it encourages systematic savings. Assuming this to be so, the effectiveness of the supposed deterrent would depend upon the investor's knowledge of the consequences of default—and, more particularly, on his knowledge of these consequences at the time he must decide whether to default or not. The Wharton Study indicated widespread ignorance of the mechanics of the front-end load plan, and to that extent the deterrence is unlikely to operate. Such deterrence as there is necessarily less pointed and dramatic than the loss of a house, consumer goods, or insurance upon non-payment of an instalment. One is less affected by knowing—if he does know—that he has a small investment relative to the amount actually paid in. Thus the argument for stimulus to systematic savings is, at best, a weak one, and the losses are out of proportion to what little may be achieved in the way of prompting savings. If this is genuinely a concern of the industry, it would seem that fairer means could be devised.

(B) Even if an investor consciously elects to default on payments and bear the adverse effects, I do not believe that it is fair and equitable to exact what is in effect a penalty, especially since the default may be prompted by economic or personal troubles or needs. To state it otherwise, such consequence is at variance with the general philosophy of the federal securities act of protecting investors, and inconsistent with one object of mutual funds in affording a better investment medium than securities selected haphazardly or ignorantly. The fact that some investors may later resume payments and get their status restored does not justify the loss to others who cannot or do not wish to resume payments. Also the fact that the investment actually made, if retained with the fund, may catch up with the heavy initial load is equally inapposite; apart from the fact that the