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INVESTMENT COMPANY ACT AMENDMENT

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HEARING

BEFORE THE

SUBCOMMITTEE ON COMMERCE AND FINANCE

OF THE

COMMITTEE ON

INTERSTATE AND FOREIGN COMMERCE

HOUSE OF REPRESENTATIVES

NINETY-SECOND CONGRESS

FIRST SESSION

ON

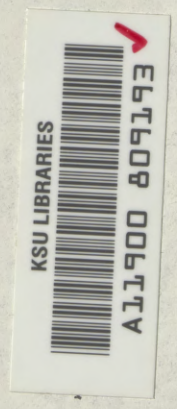
H.R. 9758 and S. 2216

BILLS TO AMEND THE INVESTMENT COMPANY ACT OF 1940,
AS AMENDED

OCTOBER 21, 1971

Serial No. 92-38

Printed for the use of the
Committee on Interstate and Foreign Commerce



U.S. GOVERNMENT PRINTING OFFICE

★ 68-678

WASHINGTON : 1971

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INVESTMENT COMPANY ACT AMENDMENT

THURSDAY, OCTOBER 21, 1971

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met, pursuant to notice at 10 a.m., in room 2123, Rayburn House Office Building, Hon. John E. Moss (chairman) presiding.

Mr. Moss. The subcommittee will be in order.

This morning we will consider bills H.R. 9758 and S. 2216 which propose in identical form to amend the Investment Company Act of 1940 to make the refund rights contained in section 27(f) inapplicable to periodic payment plans which are level loaded at 9 percent or less.

In the last session, Congress enacted comprehensive amendments to the Investment Company Act which contained many important new safeguards and protection for investors. Among these, purchases of periodic payment plans were given cancellation and withdrawal rights as a means of curtailing abuses which had arisen in connection with the sale of front-end load plans. These are contractual plans under which up to 50 percent of the first year's payments are deducted for sales charges.

Because variable annuity contracts are classified as periodic payment plans under the Investment Company Act, we now discover that new section 27(f) has the unintended effect of also granting refund rights to purchasers of level loaded variable annuities.

I can state with certainty that this was not the purpose of the subcommittee or of the Congress. And I am aware of no evidence that abuses have arisen in connection with the sale of variable annuity contracts or that purchasers of such plans require the special protection of section 27(f). As a matter of fact, I can recall no testimony during the very lengthy hearings which would support any such allegation.

The legislation before us today would correct this unintended result by making section 27(f) inapplicable to any plan in which the sales load deducted from any payment does not exceed 9 percent. Where sales charges exceed that percentage the purchaser will be afforded the refund privilege.

(The text of H.R. 9758 and S. 2216, and departmental reports thereon, follow:)

[H.R. 9758, 92d Cong., 1st sess., introduced by Mr. Moss (for himself, Mr. Broyhill of North Carolina, and Mr. Stuckey) on July 13, 1971; and S. 2216, 92d Cong., 1st sess., referred to the Committee on Interstate and Foreign Commerce on September 8, 1971, are identical as follows:]

A BILL To amend the Investment Company Act of 1940, as amended

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 27(f) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-27(f)), is amended to read as follows:

"(f) With respect to any periodic payment plan (other than a plan under which the amount of sales load deducted from any payment thereon does not exceed 9 per centum of such payment), the custodian bank for such plan shall mail to each certificate holder, within sixty days after the issuance of the certificate, a statement of charges to be deducted from the projected payments on the certificate and a notice of his right of withdrawal as specified in this section. The Commission may make rules specifying the method, form, and contents of the notice required by this subsection. The certificate holder may within forty-five days of the mailing of the notice specified in this subsection surrender his certificate and receive in payment thereof, in cash, the sum of (1) the value of his account, and (2) an amount, from the underwriter or depositor, equal to the difference between the gross payments made and the net amount invested. The Commission may make rules and regulations applicable to underwriters and depositors of companies issuing any such certificates specifying such reserve requirements as it deems necessary or appropriate in order for such underwriters and depositors to carry out the obligations to refund sales charges required by this subsection."

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
Washington, D.C., October 20, 1971.

HON. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Office of Management and Budget on H.R. 9758, a bill "To amend the Investment Company Act of 1940, as amended."

The Office of Management and Budget concurs in the views of the Department of the Treasury and the Securities and Exchange Commission in their reports on H.R. 9758, and, accordingly would have no objection to the enactment of H.R. 9758.

Sincerely,

WILFRED H. ROMMEL,
Assistant Director for Legislative Reference.

SECURITIES AND EXCHANGE COMMISSION,
OFFICE OF THE CHAIRMAN,
Washington, D.C., July 28, 1971.

Re: H.R. 9758, 92nd Congress

HON. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your request of July 16, 1971, I am pleased to send you herewith three copies of the memorandum¹ which sets forth the views and comments of the Securities and Exchange Commission with respect to H.R. 9758.

We have been advised by the Office of Management and Budget that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely yours,

WILLIAM J. CASEY, *Chairman.*

Mr. Moss. We are pleased to welcome as our first witness Mr. Walter North, associate general counsel of the Securities and Exchange Commission.

Mr. North.

¹ Editor's note. The memorandum appears on p. 3 of this hearing.

**STATEMENT OF WALTER NORTH, ASSOCIATE GENERAL COUNSEL,
SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY
SOLOMON FREEDMAN, DIRECTOR, DIVISION OF CORPORATE
REGULATION; AND ALAN ROSENBLAT, CHIEF COUNSEL, DI-
VISION OF CORPORATE REGULATION**

Mr. NORTH. Mr. Chairman, I have with me this morning the Director of the Commission's Division of Corporate Regulation, Mr. Sol Freedman, and also Alan Rosenblat, who is the Chief Counsel of that division of the Commission. These gentlemen both have considerable familiarity—more than my own—with reference to the history of this bill.

We have already submitted, 2 or 3 days ago, our statement in writing on H.R. 9758, which is identical with the testimony, except it is cast in the form of a statement, instead of the form of testimony for oral presentation, with our comment on the Senate bill, which I understand is also the subject of your hearings today, S. 2216.

Mr. Moss. Mr. North, is that the memorandum of the Securities and Exchange Commission prepared for the House of Representatives Committee on Interstate and Foreign Commerce with respect to H.R. 9758, 92d Congress?

Mr. NORTH. That is right.

Mr. Moss. Without objection that memorandum will be entered in the record.

Mr. NORTH. That is what I was going to suggest; if it is agreeable to you, I will submit it for the record and let it go at that, unless you have some questions.

(The memorandum referred to follows:)

**MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION PREPARED
FOR THE HOUSE OF REPRESENTATIVES COMMITTEE ON INTERSTATE AND FOREIGN
COMMERCE WITH RESPECT TO H.R. 9758, 92D CONGRESS**

The Securities and Exchange Commission supports H.R. 9758.

Last year in enacting the Investment Company Amendments Act of 1970, the Congress gave a holder of any periodic payment plan certificate the right to receive a full refund of all charges plus the value of his account if he chose to cancel his plan within 45 days of the mailing of the notice of his cancellation privilege. This notice had to be sent within 60 days of the issuance of the certificate. This privilege is granted by Section 27(f) of the Act.

That subsection also gave the Commission rulemaking authority to specify the method, form, and contents of the notice as well as to specify the reserve requirements it deemed necessary or appropriate in order to assure that underwriters and depositors will be able to carry out their obligations to refund these charges.

This 45-day refund right was patterned upon a pre-existing 60 day refund right which many sponsors of front-end load plans, typically those having 50 percent of the first year's payment deducted as sales load, had voluntarily accorded purchasers of front-end load plans. Under this voluntary arrangement, a purchaser was entitled to a refund of all amounts paid on a certificate within 60 days from its issuance.

The new statutory 45 day refund right differed in that it placed the risk of the market as to the moneys invested upon the certificate holder. It also extended the refund right to holders of any periodic payment plan, not merely holders of front-end load plans.

The definition of periodic payment plan certificate contained in Section 2(a)(27) of the Act makes no distinction as to the percentage deducted as "sales load." Thus, Section 27(f) had the unintended effect of providing a 45 day refund right

whether or not the sales load on any payment exceeded 9 percent. Its terms extend to single-payment and level-load plans, including many variable annuities.

When the Commission considered the implementation of this section, it was confronted with the fact that there seemed to be no ambiguity as to its meaning. The Commission could not see how it could give expression to the fact that the original purpose of the amendment was directed solely towards front-end loan plans.

The Commission also considered whether it could exercise its powers under Section 6(c) of the Act to exempt all periodic payment plan certificates on which total charges deducted from any payment did not exceed 9 percent. To exercise this exemptive authority, the Commission is required to find it "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 the Act."

This authority to grant exemptions was not exercised because the Commission was not able to satisfy itself that it would be consistent with the protection of investors to eliminate entirely this 45 day refund right. The Investment Company Amendments Act of 1970 had just provided the refund right to investors in language in which the Commission could find no ambiguity, even though the request for and the purpose of the amendment did not require that this protection be extended to this kind of a contract.

H.R. 9758 would amend Section 27(f) in accordance with the Congressional intent to afford the 45 day refund right to purchasers of those plans on which the amount of sales load deducted from any payment exceeds 9 percent of such payment. The Commission's intention with respect to periodic payment plan certificates, as originally expressed in Public Policy Implications of Investment Company Growth, (H. Rep. No. 2337, 89th Cong., 2d Sess., December 2, 1966) and subsequently expressed in the legislative recommendations arising out of that Report (including amendments to Section 27 of the Act), was to eliminate inequities arising in connection with the sale of front-end load plans. Section 27(f) as enacted goes beyond this and beyond the previous industry practice of offering 60 day refunds only on front-end load plans.

H.R. 9758 would accomplish the Commission's and Congress' intent and at the same time leave intact the protections afforded purchasers of front-end load, spread-load, and other periodic payment plans on which the amount of sales load deducted from any payment exceeds 9 percent. Therefore the Commission supports the proposed amendment.

Mr. Moss. Mr. Ware.

Mr. WARE. No questions, thank you.

Mr. Moss. Mr. McCollister.

Mr. MCCOLLISTER. I am curious, Mr. Chairman, how we came out at 9 percent.

Mr. NORTH. The nine goes back to the original Investment Company Act of 1940 and there was no change in that.

Mr. MCCOLLISTER. Thank you.

Mr. Moss. All we are really trying to do now is what we intended to do then.

Mr. MCCOLLISTER. I understand. Thank you.

Mr. NORTH. I believe that is the purport of our statement, and for that reason we are in support of the bill, of course.

Mr. Moss. Mr. Curtis, do you have any questions?

Mr. CURTIS. No; thank you, Mr. Chairman.

Mr. Moss. All right. Apparently, gentlemen, you can return to your duties.

Mr. NORTH. Thank you.

Mr. Moss. Our next witness is Mr. Lawrence J. Latto, of Shea & Gardner, on behalf of the American Life Convention and Life Insurance Association of America.

Gentlemen, if you would like, we can insert your statement in its entirety in the record and you may summarize.

STATEMENT OF LAWRENCE J. LATTO, SHEA & GARDNER; ACCOMPANIED BY PAUL J. MASON; AND ROBERT J. ROUTIER

Mr. LATTO. Thank you, Mr. Chairman.

Mr. MOSS. The statement will be placed in the record in its entirety.

Mr. LATTO. I hope I can be as brief as Mr. North.

I would like to indicate that I have accompanying me Mr. Robert Routier and Mr. Paul Mason, each of whom is an associate general counsel of American Life Convention and Life Insurance Association of America, respectively, and, as you know, both organizations have on other occasions appeared before you representing virtually all of the major insurance companies in the country.

As I indicated in our written statement, we, too, support this bill.

As the committee knows, the amendments to the Investment Company Act of 1940 that were adopted last year made a very comprehensive and complex package, and it would be miraculous if some ambiguity did not creep into some provision. That is the case here.

There is no controversy over the desirability of this amendment and we would urge that it be promptly reported and passed by the House. (Mr. Latto's prepared statement follows:)

STATEMENT OF LAWRENCE J. LATTO, ON BEHALF OF AMERICAN LIFE CONVENTION AND LIFE INSURANCE ASSOCIATION OF AMERICA

My name is Lawrence J. Latto. I am appearing here today on behalf of the American Life Convention and the Life Insurance Association of America. These two associations have an aggregate membership of 355 United States and Canadian life insurance companies which account for approximately 92 percent of the legal reserve insurance in force in the United States and which hold over 99 percent of the reserves of insured pension plans in the United States. Included in this combined membership are substantially all of the companies engaged in the variable annuity business in this country today.

We support H.R. 9758 and S. 2216 as passed by the Senate on August 6, 1971. The purpose of these bills is to make clear that provisions of Section 27(f) of the Investment Company Act of 1940 do not apply to periodic payment plans under which the amount of sales load deducted from any payment does not exceed 9 percent of such payment. Such plans are generally referred to as level-load plans. Section 27(f) was one of a number of provisions which were added to the 1940 Act by the Investment Company Amendments Act of 1970 (Public Law 91-547). We think it was the clear intent of Congress in adopting Section 27(f) that it should apply only to front-end load plans, and not to level-load plans. The SEC, however, has taken the position that Section 27(f) must be applied to level-load variable annuity plans because the Section uses the term "periodic payment plan", and the Commission has construed this term to include variable annuities. The SEC concedes that this position is contrary to the intent of Congress in passing the bill; however, they feel that the technical language does not permit another interpretation. The sole purpose of H.R. 9758 and S. 2216 is to make certain that the original intent of Congress is carried out.

A short history of Section 27(f) as adopted in 1970 may be helpful. Originally the SEC recommended the abolition of all front-end load plans, i.e., contractual plans under which deductions for sales load could be as high as 50 percent of the first year's gross payments. This recommendation was not followed. As a compromise, Public Law 91-547 amended Section 27 of the Act to provide purchasers

of front-end load plans with certain withdrawal rights. Thus, Section 27(d) now requires that, upon any withdrawal effected within the first 18 months of a front-end load plan, the purchaser must be refunded all deductions for sales load in excess of 15 percent of gross payments. As an alternative, this refund obligation may be avoided if a company, pursuant to Section 27(h), adopts a "spread load" arrangement under which deductions for sales load in the first four years of the plan do not exceed 64 percent in the aggregate or 20 percent in any one year. In either case Section 27(f) provides that a purchaser may—within a 45-day period after being given notice of such right—surrender his plan and receive the value of his account plus an amount equal to the difference between gross payments made and net amount invested. This 45-day "free look", as it has come to be called, permits an investor to reconsider a purchase which may have been made without a full appreciation of the higher sales load deductions in the early years of the plan and the substantial loss which therefore might result from an early termination of the plan.

We have made a thorough review of the extensive legislative history relating to these provisions, and it is evident that the Section 27(f) free-look provision was treated as an integral part of the front-end load provisions. Attached to this statement is an Appendix in which relevant passages from the legislative record are cited. Throughout this record three terms are used synonymously and interchangeably. They are "contractual plans", "front-end load plans", and "periodic payment plans". Variable annuity contracts have never been referred to as contractual plans. They are not, for the most part, front-end load plans.¹ But they are, as stated earlier, technically characterized by the SEC as periodic payment plans. And this is the terminology employed in Section 27(f). As a result, the Commission takes the position that this terminology cannot be read to relieve issuers of level-load variable annuity contracts from the refund requirements even though this result was not intended by the legislation.

As we said at the outset, this result was not intended. This provision is not applied to the sale of all mutual fund shares. One method of investing in mutual fund shares is through what is called a voluntary accumulation plan. Under such a plan, an investor makes periodic purchases, with each payment subject to a level-load deduction. The Commission considers such mutual fund voluntary accumulation plans not to be periodic payment plans. At least with respect to Section 27(f), we see no reason why a similar interpretation should not be available for "level-loaded" variable annuity plans. Most variable annuity contracts issued today are closely analogous to mutual fund voluntary accumulation plans in that the sales load deducted from each payment is 9 percent or less. Further, many variable annuity contracts, like voluntary accumulation plans, permit payments on an irregular schedule at the option of the purchaser. Even if payments are regularly scheduled, which may be the case either with a variable annuity contract or with a voluntary accumulation plan, there is no "penalty" for discontinuing payments since deductions for sales charges are "level-loaded."

If a free-look provision is not applicable to voluntary plans, it should also be inapplicable to level-load variable annuity contracts. The motivation for the adoption of Section 27(f) was the desire to avoid the loss that the purchaser of a contractual plan, with a first-year sales load of more than 9 percent, is likely to suffer if he discontinues his plan within the first two or three years after his purchase. This loss results not because a contractual plan is characterized as a "periodic payment plan", but because of the large first-year sales load. There is no large first-year sales load under a level-load variable annuity, and Section 27(f) should not be applicable to the sale of such contracts. We urge, therefore, that H.R. 9758 be reported favorably and promptly to the House of Representatives.

APPENDIX

EXCERPTS FROM LEGISLATIVE HISTORY OF PUBLIC LAW 91-547

A. Report of the Committee on Interstate and Foreign Commerce (House Report No. 91-1382, August 7, 1970).

The following quotation, from p. 4, illustrates that the "periodic payment plan" terminology was in fact utilized to describe front-end load contractual plans.—

Section 16 of the reported bill would amend Section 27 of the Act which deals with front-end loads on periodic payment plans (commonly referred to as contractual plans).

¹ There are a few variable annuity contracts which do provide for first-year sales loads that are more than 9 percent. Under H.R. 9758, the issuers of these contracts would be subject to Section 27(f).

B. Hearings before the House Subcommittee on Commerce and Finance on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 (Serial No. 91-84).

This citation, at p. 916 of Part 2, indicates that the Section 27 amendments were directed towards curbing abuses in the area of front-end load plans where, as stated by SEC General Counsel Philip Loomis—

* * * usually the salesman will have a set of plans which he can present to the customer of either a front-end load or a voluntary plan. He generally has an incentive to first suggest the front-end load plan, and only go to the voluntary plan if the customer will not buy the front-end load plan.

Further, at p. 867 of Part 2, SEC Chairman Hamer H. Budge stated—

It has never been disputed that the front-end load penalizes even those who complete their contractual plans. They would do better by investing the same amount in the underlying mutual fund through a voluntary plan which has an 8½ percent sales load on each payment.

C. Report of the Committee on Banking and Currency accompanying S. 2224 (Senate Report No. 91-184, May 21, 1969).

The following excerpt, at p. 2, indicates that the amendments to Section 27 of the Investment Company Act of 1940 in P.L. 91-547 were compromise provisions directed toward front-end load contractual plans—

With respect to contractual plans, the committee has not followed the original recommendation of the Commission which would have prohibited the front-end load. We have, instead, provided two alternatives which will permit a continuation of contractual plans with a front-end load, but which will substantially lessen the sales charges to investors who are unable to complete the specified payments called for under these plans during the first 3 years.

The following excerpt, at p. 18, is an illustrative example of the fact that the terms periodic payment plan, contractual plan, and front-end load plan were considered to be synonymous—

In the area of periodic payment plan, generally referred to as 'contractual plans,' the committee has not recommended elimination of the 'front-end load' feature, as originally urged by the Commission.

The following excerpt, at p. 20, shows that the refund right provided by Section 27(f) of the Act was conceived as part of the alternative treatments to be applied to mutual fund contractual plans—

As an alternative to the 'spread load' provision described above, the bill provides that a contractual plan may retain the presently authorized front-end load provided that if an investor elects for any reason whatsoever to redeem his underlying shares for cash during the first 3 years, he is entitled to receive a refund of the amount by which all sales charges paid by him exceed 15 percent of the total payments made under his plan. Under this alternative, contractual plan sponsors are required to give plan holders notification of their refund privileges and provide that plan holders may receive a full refund of the sales charge if they choose to cancel at any time within 60 days after the mailing of the original notice.

Mr. Moss. Well, thank you. Do you have any further comments you would like to make?

Mr. LATTO. No.

Mr. Moss. Mr. Ware?

Mr. WARE. No.

Mr. Moss. You succeeded in being briefer than the previous witness.

Mr. LATTO. That was my objective.

Mr. Moss. Thank you. With that the Chair would ask that the hearing room be cleared. The committee now must go into executive session for markup purposes.

(Whereupon, at 10:10 a.m. the committee adjourned.)

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