October 22, 1969

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 13754 TO THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, HOUSE OF REPRESENTATIVES

This memorandum, written in response to a request by the Committee, sets forth the Commission's views on H.R. 13754, which supplements the pending mutual fund legislation (H.R. 11995 and S. 2224) by eliminating the front-end load and equivalent surrender charges on future sales of installment face-amount certificates.

The Investment Company Act of 1940 ("Act") presently limits the total sales charge on a face-amount certificate to 7 percent of the aggregate gross annual payment to maturity, but it permits as much as 50 percent of the total payments to be made from the first year's scheduled installment payments. The provisions of S. 2224 dealing with the front-end load on installment face-amount certificates would permit a front-end load if it does not exceed more than 20 percent in the first three certificate years and 10 percent in the fourth certificate year. Those provisions would not affect the front-end loads charged on most installment face-amount certificates presently sold in the United States.

The Commission has previously recommended that the Act be amended to prohibit the front-end load on the future sale of face-amount certificates. In its Report "Public Policy Implications of Investment Company Growth",[1/] the Commission analyzed the payment experience on face-amount certificates as of the end of 1961 for 2,000 fifteen-year installment face-amount certificates sold during July 1941 and January 1945. That data indicated that only one-third of those purchasers of

1/ H. Rept. No. 2337, 89th Cong., 2d Sess. (1966).

face-amount certificates completed their payments. Since large portions of the first year's payments on those face-amount certificates had been taken as sales charges, "substantial numbers of face-amount certificate investors who did not complete their plans lost money because of the front-end sales load deduction."[2/]

During debate of S. 2224 on the floor of the Senate, it was indicated that the Committee on Banking and Currency of the Senate had considered an amendment which would have eliminated the front-end load on face-amount certificates. However, that Committee felt that further study was needed and on May 27, 1969, it requested that we conduct an in-depth study of face-amount certificate companies and report back within three months.

It specified our study should reveal the current redemption rates on face-amount certificates, the percentage of investors who suffered losses on their purchases of these certificates, the sales techniques used by face-amount certificate companies and the economic classifications of those persons purchasing such certificates, the after-tax yields obtainable on similar alternative investments, and the economic impact on the securities industry which would result if the front-end load on face-amount certificates were abolished. We conducted such a study and our Report was submitted as requested. A copy of that Report including a summary of it is attached to this statement.

When Chairman Moss of your Committee's Subcommittee on Commerce and Finance introduced H.R. 13754, he mentioned the Report and some of its conclusions. Our study reconfirmed our original conclusion that front-end load charges on face-amount certificates should not be continued. We <u>found that the investment yield on face-amount certificates held to</u>

2/ H. Rept. No. 2337, 89th Cong., 2d Sess., p. 248 (1966).

maturity is less than that realized on other savings programs and that the majority of purchasers of installment face-amount certificates do not continue payments under the plans to their stated maturity dates. It indicated that a large portion of those people who buy face-amount certificates lose money and that their losses are caused by the deduction of the front-end load from the early years' payments. For example, more than 55 percent of those persons who purchased the most popular 20-year face-amount certificates scheduled to mature from 1965 through 1968 lost money, by redeeming prior to the breakeven point, and more than 84 percent (by face amount) failed to reach maturity as scheduled.

In 1965, in an effort to develop a more saleable and retainable certificate, Investors Syndicate of America, Inc., which accounts for about 95 percent of face-amount certificate companies' assets and sales, stopped issuing certificates with a 50 percent first year front-end load and began issuing certificates with lower front-end loads, an improved yield to maturity and improved first year and immediate cash values. Despite this change, the surrender experience of this company on the certificates sold during 1965 through 1968 has continued at about the same rate as prior thereto. Thus, large numbers of face-amount certificate investors have continued to experience losses on their installment certificate investments. An investor does not reach the breakeven point on most of the certificates presently sold until after eight years' payments have been made. Since the front-end load on most installment face-amount certificates is less than 20 percent in each of the first three years and less than 10 percent in the fourth year, S. 2224 would not prevent such losses.

Therefore, after examination of the information disclosed by our in-depth study, we reasserted our earlier belief that the front-end load on installment face-amount certificates is contrary to the public interest and the interest of investors and that such practice and the practice of equivalent surrender charges be discontinued. The enactment of H.R. 13754 would implement this recommendation.

Attachments

SECURITIES AND EXCHANGE COMMISSION
SUMMARY OF REPORT ON FACE-AMOUNT CERTIFICATE COMPANIES

Section I: Introduction

On May 27, 1969, Senator John Sparkman, Chairman of the Committee on Banking and Currency of the United States Senate, wrote the Commission and requested that it conduct an in-depth study of face-amount certificate companies and report back to the Committee within three months.

Chairman Sparkman indicated that the study should reveal the current redemption rates on face-amount certificates, the percentage of investors who suffered losses on their purchases of these certificates, the sales techniques used by face-amount certificate companies and the economic classifications of those persons purchasing such certificates, the after-tax yields obtainable on similar alternative investments, and the economic impact on the securities industry which would result if the front-end load on face-amount certificates were abolished.

Chairman Sparkman requested that the Commission, on the basis of this study, recommend whether the front-end load be abolished or continued, or suggest such alternative forms of action as the Commission may recommend regarding face-amount certificates.

Section II: The Relationship of Face-Amount Certificates to the Securities Industry

Face-amount certificate companies are a small fragment of the investment company industry. As of June 30, 1969, there were 1,167 registered investment companies; only eight were face-amount certificate companies, of which only four were active. Total estimated investment company assets on that date were almost $73 billion and face-amount certificate companies accounted for slightly less than $1 billion. Thus, their assets represented 1.4 percent of estimated investment company assets and less than 0.2 percent of the $733 billion value of stocks listed on all registered securities exchanges at the end of 1968.

Face-amount certificate assets are also insignificant when compared to the amounts represented by savings deposits and United States government Series E bonds which may be considered alternatives to face-amount certificate accumulation programs. Face-amount certificate assets were less than 0.3 percent of the total of Mutual Savings Bank deposits, Savings and Loan Association deposits, deposits in Commercial Savings Banks and Series E bonds as of December 31, 1968.

One company, ISA, a wholly-owned subsidiary of IDS, accounted for 94 percent of face-amount certificate company assets at June 30, 1969, and 96 percent of the total face value of 1968 face-amount certificate sales. Moreover, a large portion of the assets of face-amount certificate companies are not invested in securities. Only 48.5 percent of ISA assets were invested in securities as of December 31, 1968.

1/ See Table II-2, p. II 4.

Total cumulative receipts of installment face-amount certificates in 1968 were approximately $90 million which is 1.3 percent of the $6.8 billion total 1968 sales of the members of the Investment Company Institute (not including face-amount certificate sales). The total amount paid in on face-amount installment sales made only in 1968 was $5.7 million. This is 0.08 percent of 1968 Investment Company Institute sales and .002 percent of the total 1968 volume of securities traded on the registered securities exchanges in the United States ($194 billion).

Consequently, this report does not deal with the securities industry generally. It is mainly about a diversified financial service organization, IDS, and one of its subsidiaries, ISA.

In October 1965, ISA discontinued the 6, 10, 15, and 20 year face-amount certificates it had previously issued and discontinued the 50 percent first year front-end load. It began selling two new installment face-amount certificates which have a 20 percent front-end load on each of the first three years' payments: the Series 15A certificate that matures 15 years after the date of issue, and the Series 22A certificate that matures 22 years after the date of issue. Since ISA began issuing its new certificates, the Series 22A certificate has accounted for 58.8 percent in number of certificates and 70.7 percent in face value of ISA's installment certificate sales. In 1968, single payment certificates accounted for 9.9 percent (by number of certificates) and 9.4 percent (by face value), and 11.8 percent of ISA's total certificate receipts.

Section III: <u>Features of the Face-Amount Certificate</u>

The feature which differentiates the face-amount certificate from an equity security is the certificate's insulation from market fluctuations. The face-amount certificate is a contract under which the issuer agrees to pay on a certain date a specified amount shown on the face of the certificate. Unlike securities issued by other types of investment companies, if the value of the assets of the issuing company declines, the certificate will not be worth less than its face-amount. Thus, the installment face-amount certificate offers a planned and systematic program for accumulating a sum of money and the certainty that, if payments are made as scheduled, the plan will provide a certain amount of dollars on a certain date in the future.

The yield to maturity on an installment face-amount certificate will vary slightly according to the frequency of payment chosen -- monthly, quarterly, semiannually, or annually. Most installment face-amount certificates are sold on a monthly payment basis. In 1968, 82 percent of ISA installment face-amount certificates were sold on a monthly payment basis and only 6 percent on an annual basis. If payment is made on a monthly basis on ISA's Series 22A certificate, the yield to maturity is 3.01 percent; on ISA's Series 15A certificates, it is 2.52 percent. 2/ Of course, the total yield to maturity, the amount stated on the face of the certificate, will not be paid as scheduled if the investor fails to make his payments when due.

If the investor surrenders his face-amount certificate in its early years, he will lose a substantial portion of his investment as a result of the front-end load charged. On most of the certificates currently being sold, the breakeven point is not reached until after 8 years. 3/ The achievement of the investor's objective might also be frustrated if he surrenders his certificate after the breakeven point but prior to its scheduled maturity date.

The basic yield on a face-amount certificate may be enhanced by additional credits which may be declared in the discretion of the Board of Directors. Additional credits are paid on the surrender value of the certificate on its "anniversary date." The anniversary date is not a calendar year; rather, it is the date on which each 12th monthly payment or its equivalent is reached. 4/

2/ The corresponding yields, if payments are made on an annual basis, would be 3.09 percent for the Series 22A certificate and 2.66 percent for the Series 15A certificates.

Although First Home Investment Corporation of Kansas, Inc. ("First Home") charges a 7 percent level load, it also exacts a surrender charge of $20 per $1,000 unit or 15 percent of the reserve maintained under the unit, whichever is less. As a result of a combination of the level load with the surrender charge, an investor who surrenders his certificate in its early years will lose a substantial portion of his capital investment. In fact, during the first three years after purchase, the percentage lost would be greater on the First Home "level load plan" than it would be on ISA's front-end load plan. Moreover, the breakeven point on the First Home level load certificate is not reached until the eleventh year after the sale.

3/ If payments are made on an annual basis, the breakeven point is reached after seven years, eight months.

4/ Certificate holders may pay amounts due on their certificate in advance. At present, any money paid on an ISA certificate in excess of the annual requirements or 12 monthly payments will accrue interest at the rate of 3 percent until applied against the scheduled payment. In the discretion of the Board of Directors, additional credits may also be applied on such advance payments. Since advance payments are not required, they represent an additional investment by the certificate holder and any return on them would be a return on that additional investment.

In 1968-1969, ISA paid additional credits of one percent on cash surrender values. 5/

Other features of the face-amount certificate include deferred taxation, loan values, death and disability features, and settlement options which permit the certificate holder to extend the maturity of his certificate for as much as 10 years (on the Series 22A) and to select payment plans which would permit him to defer receipt of the value of the certificate for an additional 20 years.

Face-amount certificate companies also issue single payment certificates. ISA's may be purchased for a minimum of $500 each, and mature 20 years from the date of issuance paying $903.06 at maturity, a yield to maturity of 3 percent. 6/ Since the total sales charge (3.4 percent) on a single payment certificate is deducted in full from the single payment, the cash surrender value on a single payment certificate exceeds, generally, the amount paid in after the first year. 7/ Although single payment certificates have many features similar to installment certificates, they have higher immediate cash values and thus the risk of loss on them is less than on installment face amount certificates.

Section IV: Sales Techniques

Face-amount certificates are sold by personal selling effort. IDS's success in this field may be explained by the large numbers of salesmen it continuously enlists and trains to carry out its selling processes. At the end of 1968, IDS's active full-time sales force was 3,900 persons. However, at the end of 1968, more than one out of four members of the IDS sales force had been with IDS for less than one year, and roughly 40 percent for less than three years.

The median income of IDS' active sales representatives in 1968 was $7,716. However, 34.9 percent earned less than $6,000 in 1968. IDS sales representatives are paid on a commission basis which does not vary according to the product sold. The amount of the Commission depends upon the size of the periodic payment made. On payments of $20 per month, the sales representative's total commission is $85.80, payable over the first three years of the plan, whether he sell a $3,000 investors accumulation plan, a $4,400 Series 15A installment certificate or a $7,500 Series 22A installment certificate.

IDS trains its sales representatives to sell installment face-amount certificates by means of a "canned interview" which it instructs them to practice until it has become mechanical. It focuses on the purchaser's financial goals and objectives ("retirement, college education for his family, business protection, business opportunities, travel, and emergencies and opportunities"), ISA's experience

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5/ Unified Funds, Inc. sells a ten-year installment single payment certificate, on which the yield to maturity is 1.88 percent if payments are made on a monthly basis and 2.20 percent if payments are made on an annual basis. Additional credits declared by Unified Funds, Inc. from 1964 through 1968 have averaged 2.50 percent, the most recent being 3 percent.

6/ Unified Fund's ten-year single payment certificate has a maximum yield of 3.04 percent and State Bond and Mortgage issues a 5-year single payment certificate which has a maximum yield to maturity of 3.05 percent.

7/ On single payment certificates issued by Unified Funds, the breakeven point may be later because the maximum sales commission is 6.5 percent.

("ISA offers a time tested proven plan that provides known results,")8/ and the importance of financial planning. Face-amount certificates are the "third cornerstone of IDS' four cornerstones of balanced financial planning."9/

In 1968, ISA's average installment face-amount certificate sale was $11,470 (face amount). The average ISA Series 22A certificate sale was $13,000 and the average Series 15A certificate sale was $7,900. Average monthly payments were estimated by IDS to be about $35. In 1967, three out of four sales of ISA installment certificates to individuals were for monthly payments of $25 or less. More than 42 percent of 1968 purchasers were younger than 30. Almost 30 percent were between 30 and 40. Thus, 72 percent of ISA certificate purchasers were under 40. More than half of ISA's installment certificate purchasers were in professional, technical and managerial groups, including technical and kindred workers.

A recent sampling of IDS customers revealed the following about its face-amount certificate purchasers: 25.7 percent have an annual family income of less than $7,500 and 53.5 percent have an annual family income of less than $10,000. Their median family income was $9,750 and the median cash reserve was $1,356. Their median holding of life insurance was $17,639 and the median holdings of other stocks and bonds was $146.

Face-amount certificates are owned by persons in every state. However, those living in four states accounted for one-third of the total face-amount certificate accounts now in force on the basis of face amount to maturity. 10/

8/ The Big Moments in Your Life; IDS Sales Literature, June 1967.

9/ Balanced Financial Planning; IDS Sales Literature, p. 2, February, 1969. The first cornerstone is a cash reserve to help meet current needs. IDS calls these "put and take" dollars to cover small everyday emergencies. For this it recommends bank accounts, savings and loan or credit associations. The second cornerstone is "adequate insurance and business and family protection." It covers emergencies created by death readjustment, and emergencies. The fourth cornerstone, investment in equities, is to provide professional management, diversification, marketability, potential growth and additional income for those goals highlighted under the 3rd cornerstone. Its emphasis is upon participation in the growth of the economy and helping to provide a hedge against inflation.

10/ The four states are Illinois, Michigan, Ohio, and Pennsylvania.

Section V: Surrender Experience

In the Mutual Fund Report, the Commission examined ISA's surrender experience as of the end of 1961 for 2,000 15-year face-amount certificates sold during July 1941 and January 1945. It found that 55 percent of those certificates had been surrendered prior to the breakeven point and that 32.1 percent had been held to maturity, or, stated differently, that about 67 percent were surrendered before maturity.11/ The ISA Series 20 certificates sold in 1945 through 1960, the data for which was collected for this study, were also surrendered prior to the breakeven point at about the same rate (between 50.7 and 56.1 percent on a face value basis of each year's sales).12/

The Series 15 certificates which ISA sold in each year from 1945 through 1960 have been surrendered prior to the breakeven point at fairly constant rates. However, they are a few percentage points less in relationship to face values of net sales (median rate 49.7 percent) 13/ than on the number of certificates basis shown in the Mutual Fund Report. For Series 15 sales made in the years 1957 through 1960, the rate of surrenders prior to the breakeven point has been just over 50 percent (on the basis of face values).

Complete data 14/ through the date of scheduled maturity is available for the ISA Series 20 certificates sold from 1945 through 1948. It reveals that only from 10.9 to 15.4 percent (on a face value basis) 15/ of the Series 20 certificates scheduled to mature in 1965 through 1968 actually do so as scheduled. From 77.3 to 81.8 percent of those Series 20 sales were surrendered prior to maturity. In other words, the current data reveals that on a face value basis, there have been even more Series 20 surrenders prior to maturity than the almost 67 percent shown for the Series 15 certificates examined in the Mutual Fund Report. 16/

The complete data 17/ through the date of scheduled maturity for the Series 15 certificates sold from 1945 through 1953 is similar to the data contained in the Mutual Fund Report with respect to the percentages of each year's sales reaching maturity. The percentage of Series 15 sales (by face value) from 1945 through 1953 which was surrendered prior to maturity ranged from a low of 64 percent for 1950 sales to a high of 71.2 percent for 1946 sales. The percentage (on a face value basis) of those certificates which reached maturity on schedule ranged from a low of 21.1 percent for certificates sold in 1945 to a high of 31.1 percent for certificates sold in 1950.18/

11/ Mutual Fund Report, pp.248-9 .

12/ See Table V-1, p. V 4.

13/ See Table V-2, p V 9. Series 15 certificates sold in 1950 had a better initial persistency. Only 41.9 percent (on a face value basis) of 1950 Series 15 sales were surrendered prior to the breakeven point.

14/ In relationship to net sales on a face-amount basis.

15/ See Table V-1, p. V 4, and Chart V-A, p. V 2

16/ Mutual Fund Report, pp. 248-9

17/ In relationship to net sales on a face-amount basis.

18/ See Table V-2, p. V 9.

On October 1, 1965, in an effort to develop a "more saleable and retainable" certificate, ISA discontinued the Series 20 and Series 15 certificates and began issuing the Series 22A and 15A certificates which had lower front-end loads, improved yields to maturity, and improved first year and immediate minimum cash values. Although this change reduces the amount and percentage of loss of those certificate holders who surrender prior to the breakeven point, 19/ the surrender experience on the new certificates does not indicate any lessening of the rate of surrenders.

The current redemption experience on ISA certificates prior to the breakeven point is no better than its earlier experience. A comparison of surrender experience through 1968 of the Series 20 certificates sold from 1960 through September 1965 with that of the Series 22A certificates sold commencing October 1, 1965, reveals that (on a consolidated number of certificates sold basis) two years after the year of sale, 26.8 percent of the Series 20 certificates and 28.2 percent of the Series 22A certificates had been surrendered. Three years after the sale the rate of surrenders for the Series 20 certificates was 34.4 percent and for the Series 22A certificates was 36.5 percent. Moreover, the pattern of surrenders of the two series for the first three years after the year of sale is almost identical.

The certificates surrendered by the third year after the year of sale have significant impact on the total surrender experience prior to the breakeven point. If surrenders of Series 22A certificates from the fourth year after the sale through the breakeven point were to continue at only half the rate (on a consolidated basis) of the Series 20 certificates for the comparable period, 45.1 percent of the Series 22A certificates would be surrendered prior to the breakeven point; if such surrenders were to continue at the same rate as the consolidation for the Series 20 certificates for that period, 59.1 percent of the Series 22A certificates would be surrendered prior to the breakeven point. 20/

Comparisons of current redemptions for the Series 15 and Series 15A certificates reveal almost the same picture relative to each other as does the comparison of current redemptions of the Series 20 and 22A certificates. However, the Series 15 and 15A certificates are being surrendered at a lower rate than the Series 20 and 22A certificates. Two years after the year of sale (on a consolidated basis), 20.5 percent of the Series 15 certificates and 23.2 percent of the Series 15A certificates (by numbers of certificates) had been surrendered. Three years after the year of sale, 31.5 percent of the Series 15A certificates and 27.0 percent of the Series 15 certificates have been surrendered. 21/

The pattern of surrenders on a consolidated basis for the first three years after the year of sale is also similar. If surrenders of Series 15A certificates continue from the fourth year to the breakeven point at half the rate (on a consolidated basis) of the Series 15 certificates sold from 1960 through September 1965,

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19/ See Chart V-G, p. V 22.

20/ Ibid.

21/ See Chart V-L, p. V 30.

it would result in 40 percent of the Series 15A certificates being surrendered prior to the breakeven point. If the rate for the Series 15A certificates continues at the same rate as the rate for the Series 15 certificates for the comparable period, it would result in 54.9 percent of the Series 15A certificates being surrendered prior to the breakeven point. In fact, on a consolidated basis, the rate of surrenders through 1968 of the Series 15A certificates sold from October 1965 through 1968 has not been less than the rate for the Series 15 certificates sold from 1960 through September 1965; if anything, it has been slightly higher.22/

State Bond and Mortgage Company also issues a 15-year certificate, Series 215, which is sold with a 50 percent front-end load. The rate of surrenders for the State Bond Series 215 certificates sold in 1965 follows the same pattern as the surrender experience for ISA's 15 and 15A certificates. However, its rate of surrenders is lower, year by year and in total, than ISA's experience for the comparable period.23/. Thus, it would appear from the comparison of the surrender experience for the same period of ISA's Series 15 and State Bond's Series 215 certificates, both sold with a 50 percent front-end load, with that of ISA's Series 15A certificates, sold with a 20 percent front-end load, and the comparison of ISA's Series 20 certificates sold from 1960 through September 1965, with a 50 percent front-end load, and its Series 22A certificates sold from October 1965 through 1968, with a 20 percent front-end load, that reducing the front-end load from 50 percent of the first year's payments to 20 percent of payments made in the first three years will not result in a decreased rate of surrenders.

In summary, the most significant factors that are revealed by our detailed study of face-amount certificates' surrender experience are that, generally speaking, (on a face value basis) the face-amount certificates sold by IDS between 1945 and 1960 that have been surrendered prior to the breakeven point at a loss approaches, if not exceeds, a majority of the amount sold; and that less than one-third of the amount sold actually reaches maturity on schedule.

22/ See Charts V-K and V-1 and pp. V 28-31, 37-9.

23/ Three years after the year of sale, 21.2 percent of State Bond's Series 215 certificates had been surrendered; 28 percent of ISA's Series 15 certificates and 27.9 percent of ISA's Series 15A certificates sold in 1965 had been surrendered.

Section VI: Yield

The basic yield to maturity on ISA Series 15A and 22A certificates depends upon the type of payment schedule and the maturity period chosen. On a monthly payment basis it is 2.52 percent for the Series 15A certificates and only 3.01 percent for the Series 22A certificates.24/ However, on the average, only 13.3 percent of the Series 20 certificates sold between 1945 and 1948 actually matured as scheduled and 27.4 percent, on the average, of the Series 15 certificates sold between 1945 and 1953 actually matured as scheduled. The yield to maturity on the ISA single payment certificate is 3 percent.

ISA has declared additional credits on its certificates every year for the past 28 years. Since 1948, they have ranged from 0.25 percent to 1.50 percent, and they have averaged 0.65 percent per year on the certificates issued from 1948 through 1965 and 0.94 percent per year on the certificates issued since 1965.

The before-tax yield to maturity on ISA certificates (including additional credits) has historically lagged behind the yields on Series E United States Savings Bonds.25/ The Series E bonds, which mature in one-third the time, would yield 0.15 of one percent more than the combined yield to maturity of ISA's Series 20—22A certificates, ISA's best yielding and best selling certificates. Since 1961, the combined before-tax yield (including additional credits) of ISA's Series 20 and 22A certificates has also been less than the weighted average annual yield on savings deposits. In 1967, the combined yield for the ISA Series 20 and 22A certificates was 0.49 percent less, on an absolute basis, and 10.9 percent less, on a relative basis, than the weighted average annual yield on savings deposits.26/ Since 1966, ISA's Series 22A certificate (including additional credits) has paid lower average annual yields than United States Government Series E savings bonds, savings and loan associations, mutual savings banks and commercial banks.27/

24/ On an annual basis it would be 2.66 percent for a Series 15A certificate and 3.07 for a Series 22A certificate.

25/ See, Chart VI-A.

26/ See Table VI-1 and the accompanying text.

27/ Ibid.

The after-tax yields on an ISA Series 20 certificate (including additional credits) would be as follows:

Tax Bracket at Time of Maturity	Percentage After-Tax Yield
20%	2.74
30	2.45
40	2.14

The after-tax yields on ISA's Series 20 certificates, including additional credits, (assuming no change in an investor's tax bracket) fall below the median yield (compounded) of the other savings media examined for investors in the 20 and 30 percent tax brackets and equal median yield for those in the 40 percent tax bracket. However, if the after-tax yield on an ISA Series 20 certificate is compared with the weighted average annual yield (compounded) on savings deposits from 1948 through 1967, assuming a constant tax rate over the period, the yield on the certificate would be greater than the yield on a weighted average.

The tax deferral feature of the ISA certificate would be of particular benefit to the investor who is in a high tax bracket at the time of accrual and in a substantially lower bracket when the certificate is surrendered or its maturity is reached.28/

A sampling of ISA's customers' records during 1968 revealed that 25.7 percent had an annual family income of less than $7,500 and 53.5 percent of less than $10,000. The median family income was $9,697. Also, more than 42 percent of ISA's installment certificate purchasers in 1968 were under 30 years old. If these purchasers were to be in a higher tax bracket at the date of maturity of their certificates than at the time interest accrued on them, the tax deferral feature would be disadvantageous to them.29/

Like all fixed dollar investments, face-amount certificates offer protection against deflation. However, if inflation occurs, their "real" value in terms of purchasing power is diminished. The Consumer Price Index has risen by 140 percent over the period between 1939 and 1967.30/ It has fallen in only two years during that period and each time the decline has amounted to less than 1 percent. An investor who purchased on ISA Series 20 certificate in 1947 would have received an average annual yield of 2.80 percent through the life of the certificate (including additional credits). However, since prices rose during this period, on the average, by 2.42 percent per year, the average "real" yield on this investment would have been 0.38 percent per year.

28/ See Table VI-3 and the accompanying text.

29/ See Table VI-2 and the accompany text.

30/ See Chart VI-B.

Section VII: Impact of the Elimination of the Front-End Load

Four companies are currently selling installment face-amount certificates; the largest by far is IDS. While certificate operations still account for the majority of IDS' net operating income,31/ the lines of business which IDS has been developing since 1940 have made increasingly larger contributions to IDS' net operating income.

Since the organization of its first fund in 1940, IDS' fund operations have grown to the point where it is now the investment adviser and principal distributor of the largest investment company complex in the United States.32/ As these funds have grown so has their importance as sources of IDS' net operating income. Between 1963 and 1968, the contribution of fund operations to IDS' net operating income increased by over 50 percent from $4.1 million to $6.7 million.33/

During the 1950's, IDS, through a wholly owned subsidiary, entered the insurance business. Between 1963 and 1968, insurance operations doubled their contribution to IDS' net operating income, rising from $0.6 million a year to $1.2 million.34/ During the 1960's, IDS organized or acquired a group of companies in various aspects of the financial field. This Finance Group more than tripled its contribution to IDS' net operating income, increasing from $0.6 million to $1.9 million, between 1963 and 1968. IDS estimates that the recent acquisition of Jefferies & Co., Inc., a broker-dealer which engages in over-the-counter business, will add $3.2 million to IDS' current after-tax income.

While the total net operating income of IDS has been growing at approximately 5.6 percent per year since 1963, certificate operations' contribution to this

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31/ See Table VII-2.

32/ The funds advised by IDS had assets of over $6.3 billion as of June 30, 1969.

33/ See Tables VII-1 and VII-2 and the accompanying text.

34/ In 1968, IDS' insurance subsidiary ranked among the top 5 percent of life insurance companies in the United States according to dollars in force.

income has been growing at only 1.7 percent per year. Thus, as the diversification of IDS has proceeded, the relative importance of the certificate operations has decreased. While in 1963 certificate operations accounted for $11.7 million, or 65.4 percent of IDS' net operating income, by 1968 they accounted for $12.7 million, or 54.5 percent.

The $12.7 million is composed of net operating income for ISA, IST & G and IDS (the Company). ISA's net operating income accounted for approximately $8.5 million. Advisory, service and distribution fees paid by ISA to IDS accounted for an additional $3.4 million of IDS' net operating income. IDS lost approximately $0.3 million on certificate distribution in 1968, leaving investment income and service and advisory fees which directly accounted for the profitability of its certificate operations.

An additional $0.8 million of IDS' net operating income from certificate operations was accounted for by fees and investment income received by IDS from IST & G certificate operations and IDS' own certificate operations. Investment income and fees from these assets would not be affected by the recommendations concerning the front-end load.

Ultimately, the effect on the IDS Group of any recommendation with respect to the front-end load on face-amount certificates would depend on what happens to ISA's $930 million asset and investment base. Any changes in the size of this base will depend upon changes in the value of ISA's underlying portfolio, and changes in its sales and redemption rates. Although in the long run the recommendation concerning the front-end load could accelerate the diversification of IDS's sources of income which started in 1940, such a recommendation should not cause a sudden or abrupt decline in IDS' income.

In 1941, when IDS discontinued the sale of its own face-amount certificates, its asset base was $989 million. At that time its investment income from these assets was approximately $7.9 million. Twenty years later, its investment income was still approximately $6.2 million.

Face-amount certificate assets represent only 1.4 percent of investment company assets at June 30, 1969; and were less than 0.2 percent of the value of stocks listed on all registered securities exchanges at the end of 1968. Whether the elimination of the front-end load would end all sales of installment face-amount certificates is conjectural. But even if such sales were to be entirely halted, the effect would be felt by only a very small fragment of the securities industry and even this effect would be a gradual one.

CONCLUSIONS

Approximately 20,000 installment face-amount certificates were sold in the United States in 1968--for which investors paid in over $5.7 million in that year alone. Cumulative installment certificate payments in 1968 are estimated at $90 million. There were over 370,000 installment face-amount certificate accounts in force at June 30, 1969, and the total face value of these installment certificates outstanding at the end of 1968 was over $2.2 billion. The average installment certificate account of the dominant company in this area has an estimated face value of $11,470. Thus, individually and in the aggregate, hundreds of thousands of persons in the United States are concerned with face-amount certificates.

Experience has shown, however, that a large portion of the people who buy face-amount certificates lose money. Such losses are caused by the deduction of the front-end load from the early years' payments. As a result of such charges, an investor does not reach the breakeven point on most of the certificates presently sold until after the payments required on the first 8 years of the certificate have been made. Of those persons who purchased the most popular face-amount certificate sold by the dominant company in this area, more than 55 percent lost money. The surrender rate on certificates sold during 1966 through 1968 by that company has continued at about the same rates as for certificates sold prior thereto, despite the fact that the newer certificates have a lower front-end load and higher immediate cash values.

The losses are particularly significant in view of the economic classification of the investors. According to a recent sample, the medium annual family income of purchasers of the best selling company's certificates in 1968 was $9,750. Some 25.7 percent of such certificate purchasers had an annual family income of less than $7,500 and 53.5 percent had an annual family income of less than $10,000. More than 72 percent of the certificate purchasers were under 40 years old.

The front-end load helps to support highly structured personal selling effort in which salesmen are trained to sell generally by means of a "canned interview". Moreover, salesmen are paid on a commission basis which depends upon the size of the periodic payment which the investor makes and does not vary according to the product sold. In general, salesmen receive the same amount for selling an equity investment as a face-amount certificate requiring the same monthly payments.

The investment yield on face-amount certificates held to maturity (including additional credits) is less than that realized from other savings programs. The after-tax yield on the dominant company's best yielding certificate fell below the median average annual yield on United States Savings

Bonds (Series E), savings associations, mutual savings banks and commercial banks for investors in the 20 or 30 percent tax brackets throughout the life of a 20-year certificate and equal the median yield for those remaining in the 40 percent tax bracket over the life of the certificate. Thus, if the elimination of the front-end load should result in face-amount certificates being sold with less intensity than at present, alternative accumulation programs with comparable after-tax benefits would still be available.

Whether discontinuing the front-end load on sales of installment face-amount certificates would end the sale of such certificates is conjectural. Even if this were to occur however, the economic impact, if any, on the securities industry would be negligible and even that effect gradual.

RECOMMENDATION

As the study indicates, the investment yield on face-amount certificates held to maturity is less than that realized from other savings programs. Furthermore, a vast majority of purchasers of installment face-amount certificates do not continue payments under the plans to their stated maturity dates. It is the practice of those companies selling face-amount certificates to impose a substantial commission on the early payments made by the investors, commonly referred to as the front-end load. Accordingly, early redemption results in a loss to the investor.

In our December, 1966 Mutual Fund Report, at page 250, we expressed our dissatisfaction with the imposition of a front-end load as it relates to face-amount certificates. Our present study confirms the basis for our original position. We therefore reassert our earlier belief that the front-end load on installment face-amount certificates is contrary to public interest and the interest of investors; accordingly, we recommend that such practice and the practice of equivalent surrender charges be discontinued.