South Carolina Law Review

Volume 28 | Issue 1 Article 3

Spring 4-1-1976

Marketing Mutual Funds and Individual Life Insurance

John P. Freeman
University of South Carolina

SOUTH CAROLINA LAW REVIEW

VOLUME 28 | APRIL 1976 | NUMBER 1

MARKETING MUTUAL FUNDS AND INDIVIDUAL LIFE INSURANCE

JOHN P. FREEMAN*

I. INTRODUCTION

There is a fundamental difference between *selling* and *marketing*:

> Selling focuses on the needs of the seller; marketing on the needs of the buyer. Selling is preoccupied with the seller's need to convert his product into cash; marketing with the idea of satisfying the needs of the customer by means of the product and the whole cluster of things associated with creating, delivering and finally consuming it.[1]

In the context of this dichotomy, there is nothing novel in the observation that the merchandising philosophies of the life insurance and mutual fund "industries" have generally been more characterized by a "selling" outlook than the customer-oriented approach that distinguishes the modern marketing concept. For years obscure business school theses and seminar speeches have

* Associate Professor of Law, University of South Carolina. B.B.A., 1967; J.D., 1970, University of Notre Dame; LL.M., 1976, University of Pennsylvania. Member, Ohio Bar.

This article is an outgrowth of research done by the author while a Fellow at the University of Pennsylvania Law School Center for Study of Financial Institutions. The author is indebted to the Director of the Center, Professor Robert H. Mundheim, for his counsel and assistance. During the summers of 1974 and 1975 the author worked with the Securities and Exchange Commission on matters related to mutual fund marketing. The views expressed herein do not necessarily reflect the views of Professor Mundheim, the Commission or the Commission's staff. The author also wishes to express his thanks to Victor Page for his very fine research assistance. This article bears a date of March 15, 1976.

1. Levitt, *Marketing Myopia*, HARV. BUS. REV., July-Aug. 1960, at 45, 50. The marketing concept is defined in one of the leading texts on the subject as follows:

> Marketing is the performance of business activities which direct the flow of goods and services from producer to consumer or user in order to satisfy customers and accomplish the company's objectives.

E.J. MCCARTHY, BASIC MARKETING 44-46 (4th ed. 1971).

questioned the quality of the marketing practices in the industries.[2] Lately, however, critical commentary concerning perceived marketing deficiencies within the two industries has been voiced in more important forums.

Regulation of marketing practices in the life insurance and mutual fund industries is currently a matter of concern on a number of fronts. A recent Senate investigation of "consumer protection problems posed by the present state of the life insurance market"[3] has matured into a proposed Consumer Insurance Information and Fairness Act[4] introduced in July 1975 by Senator Philip Hart. Seven years earlier Senator Hart had warned the insurance industry that federal "truth in life insurance" legislation would result if insurers did not improve the quality of cost disclosure practices in the sale of individual life insurance.[5] Senator Hart's admonition has had the recent effect of prompting a number of states to adopt detailed disclosure requirements.[6] Additionally, the National Association of Insurance Commissioners (NAIC) promulgated in December 1975 a Model Regulation on

2. *E.g.*, Lynch, Can Crosby Corporation be Improved? Case Study in the Marketing of Mutual Funds 76 (1968) (unpublished Advance Study Project in Lippincott Library, University of Pennsylvania) (taking the position that "the most glaring weakness" in the marketing of mutual funds is the "lack of actual marketing itself"); The Marketing Challenge, Address by Michael P. Walsh, C.L.U., Mass Merchandising Seminar of the American Management Association, in New York City, Nov. 15, 1971, *reprinted in Hearings on the Life Insurance Industry Before the Senate Subcomm. on Antitrust and Monopoly*, 93d Cong., 1st Sess., pt. 1, at 37 (1973) [hereinafter cited as *Life Insurance Hearings*] (arguing that "[t]he most fundamental change the [life insurance] industry must make is to go from an institution which sells its products to a business which *markets* its products"); *cf.* Davenport, *A Profile of Creative Marketing*, in INVESTMENT COMPANY INSTITUTE, 1975 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 38.

It should be noted that life insurers and mutual funds are by no means alone in being open to criticism for having failed vigorously to pursue consumer-oriented marketing. It has been said that "[m]any companies claim they follow the marketing concept; few understand it; and still fewer practice it." P. KOTLER, MARKETING MANAGEMENT 837 (2d ed. 1972). Further, there are signs of change in both industries. *E.g.*, Panel Discussion, *Successful Concepts for Marketing Financial Services* in INVESTMENT COMPANY INSTITUTE, 1974 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 112; Strader, *Future of Direct Selling*, in INVESTMENT COMPANY INSTITUTE, 1973 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 65, 69.

3. Senate Antitrust and Monopoly Subcommittee Press Release, Feb. 14, 1973.

4. S. 2065, 94th Cong., 1st Sess. (1975).

5. Senator Hart's role as instigator of price disclosure reform on the state level is discussed in the text accompanying notes 82-85 *infra*.

6. *See* note 107 *infra* for citation to state disclosure provisions.

Life Insurance Solicitation directed toward promoting price competition.[7]

The mutual fund industry has likewise seen some important recent developments relating to marketing practices. In 1973 the staff of the Securities and Exchange Commission conducted hearings into mutual fund distribution practices.[8] This investigation resulted in a comprehensive program designed to "enable the Commission and the industry to move toward the goal of price competition in an orderly manner."[9] Reaching that goal may have been made easier by a recent Supreme Court opinion that clarified the SEC's authority over mutual fund distribution practices.[10]

In assessing the significance of these developments, it is important to bear in mind that no longer can the marketing problems of insurers and mutual funds be divided neatly along industry lines. In the late 1960's the insurance industry made its dramatic entry into the field of consumer equity products via issu-

---

7. *See* notes 93-130 *infra* and accompanying text for a discussion of the NAIC proposal.

8. The hearings were announced in SEC Investment Company Act Release No. 7475 (Nov. 3, 1972). According to the release, the chief purpose of the hearings was to provide data so that the SEC could "re-examine traditional administrative positions and . . . explore new possibilities in order that mutual funds may be marketed more efficiently at a reasonable cost to investors." *Id.* Detailed analyses of modern mutual fund distribution systems completed prior to the start of the hearings are set forth in 2 NATIONAL ASS'N OF SECURITIES DEALERS, INC., ECONOMIC STUDY OF THE DISTRIBUTION OF MUTUAL FUNDS AND VARIABLE ANNUITIES (1972) [hereinafter cited as NASD STUDY]; SEC, STAFF REPORT ON THE POTENTIAL ECONOMIC IMPACT OF A REPEAL OF SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 (1972) [hereinafter cited as SECTION 22(d) REPORT]; SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 201-50 (1966) [hereinafter cited as PUBLIC POLICY REPORT]; SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess. (1962) [hereinafter cited as SPECIAL STUDY]; WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962); Romanski, *The Role of Advertising in the Mutual Fund Industry*, 13 B.C. IND. & COM. L. REV. 959, 964-99 (1972); *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 813-65 (1969).

9. Letter from SEC Chairman Ray Garrett to Senator John Sparkman, Nov. 4, 1974, at vii. This letter transmitted the most recent SEC study of mutual fund marketing: SEC DIVISION OF INVESTMENT MANAGEMENT REGULATION, MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 (1974) [hereinafter cited as DISTRIBUTION REPORT]. The findings and recommendations of the *Distribution Report* are discussed in part IV of this article *infra*.

10. United States v. NASD, Inc., 422 U.S. 694 (1975). The case is discussed in the text accompanying notes 362-68 *infra*.

ance of variable annuity contracts[11] and the sale of mutual fund shares.[12] Today over 50 percent of the assets of the mutual fund industry are controlled by insurers.[13] Moreover, it is possible that the interest of insurers in equity product marketing will increase significantly with the marketing of variable life insurance, an insurance-equity hybrid.[14] The new product was introduced in nine states earlier this year by the Equitable Life Assurance Society.[15]

Life insurers are not alone in their desire to exploit new markets. The New York Stock Exchange decided in 1972 to allow

---

11. The variable annuities bring a new dimension to the equity product field by pairing assumption of an equity investment risk by the annuitant with the insurer's traditional acceptance of the mortality risk that the annuitant will enjoy long life. This type of annuity is described in P. CAMPBELL, THE VARIABLE ANNUITY (1969); G. JOHNSON, VARIABLE ANNUITIES (1961); Frankel, *Variable Annuities and Variable Insurance*, 51 B.U.L. REV. 173, 182-94 (1971); Jones, *The Variable Annuity and the 1940 Act — An Uncomfortable Combination*, 3 CONN. L. REV. 144, 146-51 (1970).

12. This reversal in form on the part of the life insurance industry was sufficiently profound to move one journalist to exclaim: "It's as if the Pope had *endorsed* the pill." Sheehan, *Life Insurance's Almighty Leap Into Securities*, FORTUNE, Oct. 1968, at 142. For other reports on the phenomenon see SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess., pt. 2, 511-38 (1971) [hereinafter cited as INSTITUTIONAL INVESTOR REPORT]; Karmel, *Life Companies and the Mutual Fund Business: The Out-Heroding of Herod*, in 21 ASS'N OF LIFE COUNSEL PROCEEDINGS 165 (1970); Mattlin, *New Policies for Insurance Companies*, INSTITUTIONAL INVESTOR, Jan. 1970, at 97; Puder, *The Revolution Within the United States Life Insurance Industry*, FINANCIAL ANALYSTS J., July-Aug. 1970, at 60. For a recent update see Jordan, *Lessons Learned by Life Insurance Companies in the Marketing of Mutual Funds*, MUTUAL FUNDS FORUM, Aug. 1975, at 7.

13. Pitti, *The Competition for Financial Services: A Marketing Revolution*, BEST'S REV., Dec. 1975, at 20, 22 (Life ed.).

14. Variable life insurance here refers to products which have in common the basic features of (1) a minimum death benefit and (2) a promise to pay a death benefit and a cash surrender value which would reflect the investment performance of a separate account. The definition of separate accounts is spelled out in section 2(a)(37) of the Investment Company Act, 15 U.S.C. § 80a-2(a)(37) (1970), and rule 0-1(e) thereunder, 17 C.F.R. § 270.0-1(e) (1975). Comprehensive analyses of variable life insurance are presented in SEC REPORT OF THE DIVISION OF INVESTMENT MANAGEMENT REGULATION, VARIABLE LIFE INSURANCE AND THE PETITION FOR THE ISSUANCE AND AMENDMENT OF EXEMPTIVE RULES 20-59 (1972) [hereinafter cited as VLI STAFF REPORT]; VARIABLE LIFE INSURANCE: CURRENT ISSUES AND DEVELOPMENTS (D. Olson & H. Winklevoss eds. 1971); Blank, Keen, Payne & Miller, *Variable Life Insurance and the Federal Securities Laws*, 60 VA. L. REV. 71 (1974); Frankel, *Regulation of Variable Life Insurance*, 48 NOTRE DAME LAWYER 1017 (1973).

15. *See* Wall Street J., Jan. 7, 1976, at 3, col. 2. It was estimated in 1973 that variable life insurance would account for 20 to 40 percent of all life insurance sales within the next 10 years. Wall Street J., Feb. 1, 1973, at 2, col. 2. At present, however, there are reports of "widespread wariness . . . about whether the public is ready for it." Wall Street J., Jan. 7, 1976, at 3, col. 2.

member firms to write life insurance contracts,[16] and, as of June 1975, ninety-four New York Stock Exchange member companies had been given clearance to market life insurance.[17] With boundaries between industries becoming blurred and with marketing practices in each industry being criticized with increasing enthusiasm,[18] there is good reason to examine marketing practices and

16. This decision was effectuated through amendment of New York Stock Exchange (NYSE) rules 311.10, 318.13, 345.17(H) & (I) and 351. 2 CCH NYSE GUIDE ¶¶ 2311.10, 2318.13, 2345.17 and 2351. *See* New York Stock Exchange, Inc., Member Firm Educational Circular No. 369 (Apr. 4, 1972). The amendments permit member firms to become general agents or brokers provided premium checks are not made payable to them. Additionally, provision is made for the sale of insurance through unaffiliated general agencies or brokers. Life insurance activity by members is limited to sales only, and members may not become, or own part of, life insurance underwriters. The revised rules also contain provisions relating to supervision, surveillance of members and recordkeeping. On April 4, 1974 the NYSE's Board of Directors amended rule 318.13 further to permit member firms to sell all forms of insurance. The action was taken to allow members "to offer their customers a full range of insurance services and become fully competitive with other sellers of insurance." New York Stock Exchange, Inc., Member Firm Educational Circular No. 443 (Apr. 8, 1974).

17. Letter from Richard P. Del Bello to John P. Freeman, June 24, 1975, copy on file with the *South Carolina Law Review*. This is not to imply that the interest of equity product marketers in life insurance is of only recent development. Investors Diversified Services, Inc. (IDS) serves as an investment adviser to, and exclusive distributor for, the nation's largest mutual fund complex. IDS's wholly-owned life insurance subsidiary had life insurance sales of over $600 million in 1968; by 1971 the figure was over $1.1 billion. Statement of Investors Diversified Services, Inc., Feb. 12, 1973, at 25-26, SEC File No. 4-164. Another type of established securities industry involvement in the sale of insurance products takes the form of the offering of an equity-insurance package consisting of a periodic payment plan purchase of mutual fund shares coupled with the purchase of group credit life insurance. This type of investment vehicle is discussed in H. DENENBERG & J. FERRARI, LIFE INSURANCE AND/OR MUTUAL FUNDS (1967). Another form of mutual fund/life insurance tie-in involves the systematic purchase of fund shares, which are used as collateral for a loan that is in turn used to buy life insurance. At the end of the plan period, perhaps ten years, the shareholder cashes in his or her fund shares, with the proceeds going toward payment of the debt. Among those selling this type of investment package was the infamous Equity Funding Corp. of America. Blundell, *A Scandal Unfolds*, Wall Street J., Apr. 2, 1973, at 1, col. 6.

18. Appearing at the Senate Hearings into life insurance marketing, Ralph Nader characterized the life insurance industry as a "smug sacred cow" that has long been "feeding the public a steady line of sacred bull." *Life Insurance Hearings*, pt. 1, at 19. Not to be outdone, Pennsylvania's former insurance commissioner Herbert S. Denenberg argued that Nader's figure of speech did not state the case strongly enough, since "[b]oth the cow and the by-product of the bull are valuable and useful farm commodities." *Id.*, pt. 3, at 1536. Denenberg went on to call individual life insurance "one of the leading consumer frauds." *Id.* at 1537. Numerous other witnesses at the Senate hearings, while avoiding the hyperbole of Nader and Denenberg, joined the two consumer advocates in questioning the efficacy of present practices used to market individual life insurance and in suggesting the need for correction through regulatory action.

regulation of the two industries in a combined study. This article offers an evaluation of regulation of life insurance and mutual fund marketing in the context of product price — the marketing decision variable[19] that has been called "[t]he single most important characteristic of a market offering."[20]

The initial part of the article focuses on the nature of each of the products under consideration, viewing the products in relation to their respective positions in the marketplace and the competitive pressures they exert and must face. The discussion points out numerous parallels between the marketing positions of the two industries, including parallels in areas where existing marketing practices have been judged deficient. It is noted that a major complaint concerning the marketing methods of both industries is that price competition has been stunted. In subsequent sections of this article attention is given to possibilities for spurring price competition in the two industries. In the case of the

---

At the SEC's 1973 hearings into mutual fund distribution, barnyard imagery was likewise the order of the day. Among those presenting testimony on the opening day of the hearings was David Silver, General Counsel of the Investment Company Institute, a trade association of mutual funds accounting for over ninety percent of the mutual fund industry's assets. The gravity of the marketing problems confronting the mutual fund industry was snapped into focus when, in a pointed reference to lagging fund sales and rising redemptions, an SEC staff member asked Mr. Silver whether, in the case of its distribution system, the mutual fund industry was not "riding a dead horse." Official Transcript of SEC Hearings in the Matter of Mutual Fund Distribution and the Potential Impact of Repeal of Section 22(d) of the Investment Company Act of 1940, at 182 [hereinafter cited as Distribution Hearings Transcript] (statement of Lewis Mendelson). For further discussion of the "dead horse" comment, see Bogle, *The Future of Mutual Funds*, in INVESTMENT COMPANY INSTITUTE, 1973 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 22; Letter from Lewis Mendelson, in FUNDSCOPE, Dec. 1973, at 2.

19. In his popular marketing text Professor E. Jerome McCarthy posits the existence of four marketing decision variables—the "four P's" of marketing: product, price, promotion and place (or distribution channel). E.J. MCCARTHY, *supra* note 1, 44-46. Each "P" represents a factor under the control of the marketer that can be used to influence sales, hence the designation marketing decision variables.

20. Thorelli, *Consumer Information Policy in Sweden — What Can Be Learned?*, J. MARKETING, Jan. 1971, at 50, 52. The significance of the pricing element in the marketing equation was underscored by President Kennedy in his 1962 consumer protection message to Congress. The message enumerated a list of what were called "consumer rights." Among them were

> [t]he right to choose — to be assured, wherever possible, of access to a variety of products and services at competitive prices; and in those industries where competition is not workable and government regulation is substituted, an assurance of satisfactory quality and service at fair prices.

H.R. Doc. No. 364, 87th Cong., 2d Sess. 2 (1962).

life insurance industry the primary focus is on the nature and potential impact of efforts at the state and federal level to promote price competition through cost disclosure at the point of sale — a consumer protection technique which has been mandatory in mutual fund marketing for decades. Also included in the life insurance discussion is commentary on opportunities for price discounts in light of state antidiscrimination and anti-rebating laws. For the mutual funds, the chief focus is on efforts by the SEC to increase price competition through the relaxation of regulatory restraints on the use of such tools as advertising and mass merchandising — marketing tools long used by insurers — including comment on sources of money to finance advertising. Discussion also includes the necessity for the SEC's use of exemptive rules to empower funds and their underwriters to adopt voluntarily measures designed to promote price competition.

II. PRODUCT MARKETING POSITIONS

Obviously, significant differences exist between life insurance and mutual funds. At one end of the financial services spectrum is life insurance with its predominant feature of a guaranteed amount of money payable at death. In the case of whole life insurance there are often supplemental features included in the insurance contract, such as nonforfeiture values, loan provisions and settlement options. At the other end of the financial services spectrum, mutual funds are clearly a more investment risk oriented product, with such customer services as dividend income and capital gains reinvestment, voluntary accumulation and withdrawal plan arrangements, exchange privileges, and letters of intent all being subsidiary to the central features of professional money management, diversification of risk, and issuance of a redeemable security.[21] The public views the purchase of life insurance as a duty,[22] but does not similarly exalt fund ownership.[23]

---

21. "Mutual funds" are defined for present purposes in section 5(a)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-5(a)(1) (1970). A detailed discussion of the ancillary services that many mutual funds offer their shareholders is presented in 1 NASD STUDY III-30 to -35, III-37 to -39, III-49 to -54.

22. Walsh, *supra* note 2, at 40. According to a recent survey, sixty-four percent of consumers polled were found to agree with the statement that: "Today life insurance is

The marketing positions of the two industries may be further differentiated by the channels that each uses to distribute its product. A survey made by the United States Senate Antitrust and Monopoly Subcommittee revealed that a majority of the large life insurance companies contacted did more than 90 percent of their business through their own sales forces.[24] The survey's results indicate that much of the life insurance industry's sales force consists of agents who offer a very limited range of brands. In contrast, the mutual fund industry as a whole has come to rely heavily on New York Stock Exchange member firms for distribution.[25] The many funds that use this road to market

as much of a necessity as food, clothing and shelter." LIFE INSURANCE AGENCY MANAGEMENT ASS'N, LIFE INSURANCE CONSUMERS 4 (1974).

23. A survey of mutual fund shareholders found that 53 percent of those polled viewed fund ownership as a "luxury." Amthor, *Building Public Confidence in Equity Investments*, in INVESTMENT COMPANY INSTITUTE, 1973 PROCEEDINGS OF GENERAL MEETING 90, 92. The same Louis Harris poll showed that in the public's eye mutual funds trail such investment media as bonds, stocks and savings accounts in categories ranging from liquidity appeal to "best for growth" and "best protection from inflation." Harris, *Building Confidence in Financial Institutions in the Seventies*, FINANCIAL ANALYSTS J., Mar.-Apr. 1973, at 24, 26. Another survey of the public's views on investment conducted for the Securities Industry Association showed a similarly low esteem for mutual funds in comparison with other savings vehicles. OPINION RESEARCH CORP., THE PUBLIC AND INVESTORS EVALUATE THE SECURITIES INDUSTRY (1972). According to securities industry salesmen, in the recent past, issues of some non-fund securities have been "easier to sell because they are not mutual funds." A Glance Backward and a Look Forward, Address by Alan Mostoff, 1973 Mutual Funds Conf., in Mexico City, Mar. 6, 1973, *reprinted in* BNA SEC. REG. & L. REP., No. 193, at E-1, E-4 (Mar. 4, 1973).

The disfavor of the funds may be in part a backlash brought on by the short-lived "go-go" boom period of the late 1960's. For insight into the go-go craze, see "ADAM SMITH," SUPERMONEY 78-95 (1972); "ADAM SMITH," THE MONEY GAME 207-250 (1968); J. BROOKS, THE GO-GO YEARS 127-49 (1973); "Adam Smith," *Notes from the Librium Society: End of the Performance Game*, NEW YORK, Aug. 18, 1969, at 24; Louis, *Those Go-Go Funds May Be Going Nowhere*, FORTUNE, Nov. 1967, at 143.

24. See *Life Insurance Hearings*, pt. 4, at 2899 for a listing of 26 companies, with a breakdown for each company as to the percentage of business done in 1972 with agents, brokers or others. Sixteen of the companies did more than 90 percent of their business with their own agents. Included among the companies surveyed were Equitable, John Hancock, Metropolitan, New York Life, and Prudential. According to material presented to the subcommittee, these 5 companies have written over 40 percent of the insurance industry's ordinary life insurance coverage and control over 44 percent of the life insurance industry's assets. *Id.*, pt. 1, at 7 (written statement of Ralph Nader). According to data received by the subcommittee, each of the 5 companies did at least 95 percent of its 1972 business with its own sales force. *See id.*, pt. 4, at 2899.

25. It has been estimated that exchange members account for approximately 65 percent of mutual fund sales by broker-dealers. DISTRIBUTION REPORT at 33. Fund sales accounted for less than two percent of NYSE member firms' gross revenue in 1970. *Id.* at 34.

are forced to compete for favor with other funds and with other equity products offered by the distributors.

Notwithstanding the existence of important differences, there are some intriguing parallels between the marketing positions of mutual funds and life insurance. For example, both mutual funds and life insurance are at bottom financial services through which the purchaser contemplates the receipt of a future delivery of money, and to some extent the products do compete with each other for the public's savings dollar.[26] Also, while it is true that ownership of mutual funds differs greatly from life insurance ownership in terms of investment risk, the jargon of whole life insurance nevertheless is sprinkled with such non-mortality related terms as "savings" and "dividends."[27] Further, there is a good deal more to the investment aspect of whole life insurance than mere jargon.[28]

There are other significant parallels between the mutual fund and life insurance industries. In both industries the products are properly classified as "intangibles" and their distribution is largely dependent on creative or "specialty" sales personnel who move merchandise which could not otherwise be sold in equal volume.[29] In both industries the marketplace is segmented, with some variations in product design and marketing approach re-

26. *Cf.* H. DENENBERG & J. FERRARI, *supra* note 17 (comparing endowment life insurance and the insured mutual fund contractual plan); Lipp, *Exactly How Do Mutual Funds Compare with Life Insurance?*, National Underwriter, Jan. 22, 1966, at 4, col. 1, 6 (Life ed.) (arguing the superiority of life insurance). A mutual fund executive has analyzed the competition as follows:

> Historically, competition between mutual funds and insurance has largely been at the margin. By this, I mean that the mutual fund industry has consistently taken the position that an investor should have adequate life insurance in terms of death protection before considering a mutual fund investment.

Life Insurance Hearings, pt. 3, at 1904 (testimony of John Bogle). For further comment on competition "at the margin," *see Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., pt. 3, at 521 (1969) [hereinafter cited as *1969 House Hearings*] (testimony of Davidson Sommers).

27. For Mrs. Virginia Knauer's criticism of the confusion engendered by such terms, see *Life Insurance Hearings*, pt. 2, at 1322. For a techical discussion of the terms see J. BELTH, LIFE INSURANCE: A CONSUMER'S GUIDE 21-24 (1973).

28. Indeed, subsequent discussion will show that a basic tenet of the cost disclosure scheme advocated by Senator Philip Hart is that it is possible to derive percentage rates of return on the savings element of whole life policies. *See* text accompanying note 147 *infra*.

29. McMurry, *The Mystique of Super-Salesmanship*, HARV. BUS. REV., Mar.-Apr. 1961, at 113, 114.

sulting from efforts to appeal to different market segments.[30] In both industries the use of advertising to promote sales traditionally has been confined to cultivating a brand image rather than differentiating the advertised product on the basis of such things

30. As to market segmentation in the life insurance industry, see AMERICAN LIFE INSURANCE ASS'N SUBCOMM. ON COST COMPARISONS, REPORT TO THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS LIFE INSURANCE COST COMPARISON (C3) TASK FORCE ON RESEARCH PROJECT NUMBER 5, at 12 (distinguishing between two "easily recognizable" markets: a "select" market generally made up of the higher-income portion of the population, and a "broad" market encompassing all segments of the market); Life Insurance Cost Disclosure, Address by H. Daniel Gardner, American Life Insurance Ass'n Legal Section Seminar 5, Jan. 27, 1975 [hereinafter cited as Gardner Address] (stating that the life insurance market is "fractionalized" with a considerable number of companies active in a limited area or a particular market defined by a socio-economic group or a type of agency force); *Life Insurance Hearings*, pt. 1, at 715 (testimony of E.J. Moorhead) (noting that all insurance companies "are not all strung out on a list, all working in the same market"); *Life Insurance Hearings*, pt. 2, at 916 (written statement of S.C. DuRose); *id.* at 1093-94 (written statement of Professor Spencer Kimball). One example of a company that has successfully exploited market segmentation is United Services Automobile Association, a cooperative owned jointly by more than 950,000 members that markets insurance to United States Armed Forces officers. *See generally* E. DUNN, USAA: LIFE STORY OF A BUSINESS COOPERATIVE (1970).

The contours of the mutual fund marketplace have been described as follows:

> The market for mutual funds is quite unlike the market for goods and services sold in competitive markets, insofar as the aggregate demand reflects segmented markets, of which there are at least three. There is a demand by knowledgeable investors for no-load funds. At the other end of the scale is the demand by uninformed investors for load funds; the most important characteristic of that market is that it is wholly dependent on the level of effort of salesmen. In a normal competitive market, the supply is created by demand, here the demand is supply-created. In between these two is a market with a demand for load funds, where investors are aware of the existence of no-load funds, but nevertheless buy load funds, generally for the reason that they expect better performance.

An Economist's View of Sections 22(b) and 22(d), Address by Dr. Stephen F. Sherwin, at the 1973 Mutual Funds Conference Sponsored by the Federal Bar Association and Commerce Clearing House, in Mexico City, Mar. 6, 1973, copy on file with the *South Carolina Law Review*. This analysis of the mutual fund market is borne out by the testimony of one no-load mutual fund executive given at the mutual fund distribution hearings, who stated that it is almost "impossible to crack the ice" through advertising for no-load sales "when you go outside the somewhat aware [of mutual funds] public." Distribution Hearings Transcript, at 1191 (testimony of William B. Thompson).

It is interesting that a mutual fund group has begun offering a blending of marketing strategy for the life insurance and investment company industries through what has been styled "no-load" life insurance. The product is designed to appeal to "self-motivated insurance buyers." *See From No-Load Funds to No-Load Insurance*, FORBES, June 1, 1973, at 70; Richards, *Ripple on the Pond or a Tidal Wave?*, BEST'S REV., July, 1974, at 36, 40 (Life ed.).

as lower price or superior service.[31] In both industries the product is said to be "sold and not bought,"[32] and competition manifests itself less in downward pressure on prices than in strenuous efforts to attract salespersons.[33] In both industries sales force turno-

---

31. *E.g.*, *Life Insurance Hearings*, pt. 1, at 31-32 (testimony of Ralph Nader referring to identity advertising by insurers). For an explanation of how Lee Hines' purchase of a "piece of the Rock" helped cure his insomnia, see TIME, Mar. 19, 1973, at 36.

At the mutual fund distribution hearings, there was abundant testimony that having a brand name investment company product makes it much easier to sell. Examples of brand names mentioned at the hearings were John Hancock, Paul Revere, Montgomery Street, Bank of America, First National City Bank, Dreyfus Fund and Oppenheimer Fund. *E.g.*, Distribution Hearings Transcript, at 874 (testimony of John D. Weller); *id.* at 1068 (testimony of Roger S. McCollester). One fund dealer testified as follows concerning the reaction to fund advertising by the Oppenheimer and Dreyfus organizations:

> Well, it has been very helpful. We are in the New York area and we got the benefit of the Dreyfus lion and the Oppenheimer four hands, and it is nice to sit in somebody's living room and say, you know, this fund, that is the line that [has the] lion [that] comes out of the subway.
>
> . . . .
>
> I would say for the small broker-dealer he has to use some sort . . . of prestige item. This gives him that third party prestige item. For instance, a New York Stock Exchange firm will call you up and say "My name is Joe Brown, a member of such and such a firm, members of the New York Stock Exchange."
>
> That also gives an image. We can't use that image, so we use the lion.

Distribution Hearings Transcript, at 874-75 (testimony of John D. Weller).

It is recognized that a brand image can convey a sense of "reliability" and "[i]t is perhaps worth recalling that one of the customer's motives is to have a feeling of confidence in the product he buys. Some, but not all, consumers are willing to pay added money for confidence." Bauer, *Consumer Behavior as Risk Taking*, in RISK TAKING AND INFORMATION HANDLING IN CONSUMER BEHAVIOR, 23, 25-26 (D. Cox ed. 1967).

32. In the case of life insurance, the statistical consultant to the Senate Antitrust and Monopoly Subcommittee testified at the 1973 hearings that: "One thing that you have to keep in mind is that a great majority of purchasers of life insurance purchase it because they are sold, not — in spite of what they say — because they take the initiative in buying the policy." *Life Insurance Hearings*, pt. 4, at 2255 (testimony of Alfred G. Whitney). *See also id.*, pt. 2, at 1245-46 (testimony of Mark Dorfman). The same position is taken in the mutual fund industry. *E.g.*, Distribution Hearings Transcript 306 (testimony of Franklin R. Johnson).

33. As to competition for life insurance agents, see *Life Insurance Hearings*, pt. 1, at 32, 33, 555 (remarks of Peter Petkas, Ralph Nader, and Joseph M. Belth, respectively). It appears that competition for agents' favor has long been the standard distribution strategy in the insurance industry. A detailed study of the insurance industry made at the turn of the century is said to have reported that it was "not uncommon" for sales commissions to reach 100 percent of the first year's premium. "The companies attempted to justify these large expenditures for commissions on the plea that they were rendered necessary by competition." J. MACLEAN, LIFE INSURANCE 594 (1962). For similar comments concerning the fund industry, see PUBLIC POLICY REPORT 21, 208-09, 221; *The Mutual Fund Industry: Challenge or Crisis?*, FUNDSCOPE, Nov. 1972, at 11, 18; *1969 House Hearings*, pt. 2, at 863 (testimony of SEC Chairman Hamer Budge).

ver is said to be very high.[34] In both industries there is serious concern that customers are subjected to abusive sales practices.[35] And in both industries the lasting interest of salespersons in their customers is open to question.[36]

That the life insurance and mutual fund industries exist in similar states of imperfect or monopolistic competition[37] should not be surprising since their competitive contours have been shaped by the same types of forces. In the case of the life insur-

---

Nobel laureate Paul A. Samuelson has described competition for mutual fund dealers in these terms:

> The mutual fund industry falls into the category of . . . monopolistic or imperfect competition.
>
> Imperfect or monopolistic competition, is a situation of free entry with a large number of sellers.
>
> You should think of barbershops where everybody is free to come into the industry and where holding up a high price for haircuts does not mean higher profits for anybody. It simply means the business gets divided among more and more people . . . .
>
> There is no tendency in such a . . . situation to bring loads down 1 or 2 or a few percent.
>
> Instead, competition takes the form of attracting into the industry and keeping in it a larger flock of salesmen.

Hearings on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., pt. 1, at 351 (1967).

34. Turnover in life insurers' sales forces is discussed at notes 216-17 *infra* and accompanying text. For commentary on mutual fund sales force turnover, see PUBLIC POLICY REPORT 245; *Hearings Before the House Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., pt. 2, at 701-02 (1967) (testimony of former SEC Chairman Manuel Cohen).

35. *E.g.*, *Life Insurance Hearings*, pt. 4, at 2254-55 (testimony of Alfred Whitney) (the life insurance industry's high rate of early lapsation is "a serious problem" and is caused primarily by the "inappropriate sale"). The lapsation problem is discussed further in notes 218-20, 224 *infra* and accompanying text.

A 1973 Louis Harris poll of mutual fund shareholders disclosed that many of those polled believed that their investment was overpromised. *See* Harris, *Building Confidence in Financial Institutions in the Seventies*, FINANCIAL ANALYSTS J., Mar.-Apr. 1973, at 24, 25. Some of this concern may be attributable to the fad of go-go fund speculation during the late 1960's. *See* SECTION 22(d) REPORT 39-40; *cf.* note 23 *supra*.

36. Orphan accounts are a problem in both industries. *E.g.*, Distribution Hearings Transcript 1128 (testimony of George Washburn); Walsh, *supra* note 2, at 39; Rubens, *One Answer to Redemptions*, INVESTMENT DEALERS DIGEST, Feb. 6, 1973, at 64. Further evidence of inadequate post-sale service comes in the form of a recent study of widows which reported that fewer than 40 percent of the widows who were beneficiaries of life insurance policies had help from an agent in processing claims, and fewer than 20 percent were advised about the choice of a settlement option at the time their claims were being settled. 1 LIFE UNDERWRITER TRAINING COUNCIL & LIFE INSURANCE MANAGEMENT ASS'N, THE WIDOWS STUDY 62-63 (1970).

37. The designation is Paul A. Samuelson's. *See* note 33 *supra*.

ance industry, intrabrand price competition (featuring price differences for a given coverage written by one company) is generally viewed as being illegal, while interbrand competition (price competition between companies) is said to be muted because of consumer ignorance. These factors have led to a life insurance marketplace where "it has been estimated that there is no competition in 90% of the sales."[38] And it is precisely these same factors — the threat of illegality at the intrabrand level and a lack of consumer sophistication at the interbrand level — that have combined to forestall vigorous price competition in the mutual fund industry.[39] In the remaining sections of this article some effort will be made to explore areas where pressure may be exerted to imcrease price competition in the life insurance and mutual fund industries.

III. Product Pricing For Individual Life Insurance

A. *Introduction*

It has been observed that: "[T]he market for individual life insurance is characterized by a lack of effective price competition."[40] In appraising the significance of this claim, it should be

38. *Life Insurance Hearings*, pt. 2, at 910 (written statement of S.C. DuRose). For additional commentary on competition in the life insurance industry, *see* note 33 *supra* and notes 40 & 172 *infra*.

39. *See* notes 232-35 *infra* and accompanying text. According to the Justice Department:

> In an effective market there is competition between sellers of different products (interbrand competition) and between different sellers of the same product (intrabrand competition). Competition in the mutual fund industry now is limited solely to interbrand competition — competition between different funds. Intrabrand competition does not exist; each fund sets the sales load (expressed in terms of a percentage of net asset value), prints it in the prospectus, and all dealers must adhere to that load because of the provisions of § 22(d).
>
> The absence of intrabrand competition resulting from § 22(d) might have been offset by vigorous interbrand competition among mutual funds with respect to sales loads, but such has not been the case. . . . The detriment to investors from such high sales loads is indicated by the fact that a reduction in the load of 1% could save them $45 million annually.

Comments of the United States Dep't of Justice, Feb. 2, 1973, at 5-6, SEC File No. 4-164: (Footnotes omitted).

40. Belth, *Price Disclosure in Life Insurance*, 1972 Wis. L. Rev. 1054, 1056. To the same effect, see *Life Insurance Hearings*, pt. 2, at 1088 (written statement of Professor Spencer Kimball). On the other hand, it has been argued that

> an examination of the prices of life insurance products of . . . the largest 20 companies over the last 20 years or 25 years, will show clear and incontrovertible evidence that the prices of these products . . . have been coming down. And, it

borne in mind that the present market for life insurance is one with over 1800 companies[41] holding assets of $263 billion[42] and insuring 145 million[43] Americans with coverage of nearly $2 trillion[44] written by over 450,000 licensed salespersons.[45] The largest segment of the life insurance market belongs to individual life insurance (both whole life and term bought individually), which accounts for over one-half of the industry's assets.[46]

It is surely extraordinary that an industry of these dimensions, marketing a product having an essentially standardized nature, could prosper to such an extent without the eventual outbreak of vigorous price competition. And yet industry critics, such as former Pennsylvania Insurance Commissioner Herbert S. Denenberg, are able to support their claims of ineffective price competition with studies showing cost variations of up to 170 percent for equal whole life insurance coverage.[47] Cost variations

---

> seems to me, the fact that prices to the applicants have been improving is evidence of the fact that there is price competition.

Life Insurance Hearings, pt. 2, at 1353 (testimony of Edwin Matz). The price conscious segment of the individual life insurance market has been characterized as a "small minority" of buyers, but one that is "steadily increasing" in size. *Life Insurance Hearings*, pt. 1, at 692 (testimony of Ernest J. Moorhead). A survey of consumers disclosed that 45 percent of those surveyed had been exposed to the traditional method of portraying life insurance costs and, of those, 63 percent reported that the method was used to make comparisons among companies. LIFE INSURANCE MARKETING & RESEARCH ASS'N, CONSUMERS' REACTIONS TO LIFE INSURANCE POLICY COST COMPARISON METHODS 3-4 (1975).

41. INSTITUTE OF LIFE INSURANCE, 1975 LIFE INSURANCE FACT BOOK at 83 (listing 1,810 companies in existence in 1974). Despite the large number of companies, it has been estimated that "if one were to examine the policies of about 100 companies, one could cover almost all the companies whose agents a typical buyer is likely to encounter." Gardner Address, *supra* note 30, at 11-12. For more on the power of large companies in the life insurance marketplace, see Cummins, Denenberg & Scheel, *Concentration in the U.S. Life Insurance Industry*, 39 J. RISK & INS. 177 (1972); *cf.* note 24 *supra*.

42. INSTITUTE OF LIFE INSURANCE, *supra* note 41, at 9.

43. *Id.*

44. *Id.*

45. *Id.* at 93. The last survey of employment in life insurance was in 1967. It showed that 740,000 persons worked in life insurance, either exclusively or with other kinds of insurance. The total number of people working in all fields of insurance during that year was slightly over 1.3 million. Of the 450,000 life insurance sales personnel, it was determined that 220,000 earned over one-half of their income from the sale of life insurance. *Id.*

46. *Id.* at 9. The Institute of Life Insurance categorizes such insurance as "ordinary" life insurance. That designation is avoided in this article to prevent confusion. *Cf.* R. KEETON, BASIC TEXT ON INSURANCE LAW 13 (1971).

47. *Life Insurance Hearings*, pt. 3, at 1516 (statement of Herbert S. Denenberg). The most exhaustive study of life insurance costs yet accomplished was prepared as a joint project by the Senate Subcommitte on Antitrust and Monopoly and the NAIC Life Insurance Cost Comparisons (C3) Task Force. In brief, the study analyzed each of the top three

of up to 140 percent have been reported for term life insurance.[48] Moreover, a study by the Pennsylvania Insurance Department has disclosed that companies offering relatively low cost coverage are just as financially sound and equally as capable of giving good service as high cost companies.[49]

Analysts of the insurance marketplace have attributed this perceived lack of price competition to an absence of market "transparency" — a phenomenon that is associated with consumer ignorance.[50] Informed buyers are essential if competition is to flourish,[51] and according to the insurance industry's critics, the

---

selling policies of approximately two hundred companies — which accounted for roughly 95 percent of the new and renewal straight life insurance business in 1972. Information about the policies was analyzed as of July 1, 1973, with each policy being measured by eight different cost comparison methods and using different assumptions. Altogether, each policy was measured 31 times for 4 selected ages, 6 policy sizes, and 4 policy time periods. 121 CONG. REC. S 11,975-76 (daily ed. July 8, 1975) (remarks of Senator Hart). Among other things the study showed that the company "retention" (the amount a company keeps to pay expenses and make a profit — from the policyholder's point of view) over 40 years for 163 participating $25,000 whole life insurance policies varied from $630 to $3,409 — a variation of over 500 percent. *Id.* at S 11,976. For a detailed analysis of the study's purposes and methodology, see *Life Insurance Hearings*, pt. 4, at 2218-2230 (testimony and written statement of E.J. Moorhead); *id.* at 2261 (cover sheet of study). The material gathered through the pricing study is summarized in *id.* at 2262-2631. Citations to other recent analyses of life insurance cost comparison studies are collected in Kimball & Rapaport, *What Price "Price Disclosure"? The Trend to Consumer Protection in Life Insurance*, 1972 WIS. L. REV. 1025, 1026 n.8.

Two leading works on insurance price disclosure by a central figure in the effort to provide consumers with price information are J. BELTH, LIFE INSURANCE: A CONSUMER'S HANDBOOK (1973), and J. BELTH, THE RETAIL PRICE STRUCTURE OF AMERICAN LIFE INSURANCE (1966). Belth's *Consumer's Handbook* showed a range of from $652 to $1,481 in the amount retained by a company for payment of expenses and for profit during the first 20 years of a $25,000 whole life insurance policy issued to a male aged 35 in 1970. J. BELTH, LIFE INSURANCE: A CONSUMER'S HANDBOOK 64-65 (1973).

48. *Life Insurance Hearings*, pt. 3, at 1516 (statement of Herbert S. Denenberg).

49. *Id.* at 1517. *Cf. id.*, pt. 2, at 914, 943-45 (written statement of S.C. DuRose and accompanying exhibit comparing "high cost" and "low cost" companies in terms of lapses; net cost; margins for contingencies; required interest; expenses; mortality; and the quality of the companies' bonds, mortgages and net yield).

50. *See* Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry into the Theory of Insurance Law*, 45 MINN. L. REV. 471, 494-95 & n.90 (1961); *cf.* J. BELTH, LIFE INSURANCE: A CONSUMER'S HANDBOOK 178-87 (1973); *Life Insurance Hearings*, pt. 3, at 1518-22 (written statement of Herbert S. Denenberg); *id.* at 1922 (testimony of Peter Schuck).

51. *See* Kimball & Hanson, *The Regulation of Specialty Policies of Life Insurance*, 62 MICH. L. REV. 167, 182 (1963); *cf.* Aaker & Day, *Introduction: A Guide to Consumerism*, in CONSUMERISM: SEARCH FOR THE CONSUMER INTEREST 1, 8-9 (Aaker & Day eds. 1971); Dorfman, *Workable Product Competition in the Life Insurance Market*, 39 J. RISK & INS. 613, 616-17 & n.15 (1972). Senator Hart emphasized this point in his remarks accompanying the introduction of federal disclosure legislation. 121 CONG. REC. S 11,977 (daily ed. July 8, 1975).

high degree of product complexity and lack of reliable price information at the point of sale in the individual life insurance market make it difficult for buyers to intelligently weigh the price factor when buying life insurance.[52] In short, it is claimed that companies marketing individual life insurance have chosen not to engage in price competition, but rather to differentiate their products along non-price lines, thereby cultivating consumer ignorance and converting it into market power.[53]

The industry's critics have made an impact on the way individual life insurance is marketed. Their criticism is largely responsible for pressures being exerted at the state and federal level aimed at breaking up the logjam of consumer confusion which has been perceived by these critics. Initial discussion will focus on disclosure and cost comparison proposals at the state level. Subsequently, attention will be shifted to a proposed federal regulatory system designed to heighten competition in the life insurance marketplace. The final segment of the life insurance pricing analysis will consider some possible effects of the disclosure and cost comparison proposals on consumers, sales personnel and company managements.

52. *E.g.*, *Life Insurance Hearings*, pt. 1, at 20, 32 (testimony of Ralph Nader); *id.*, pt. 2, at 1322 (testimony of Virginia Knauer); *id.*, pt. 3, at 1521 (written statement of Herbert S. Denenberg); Belth, *supra* note 40, at 1055-56, 1069; *cf. Life Insurance Hearings*, pt. 2, at 1102 (testimony of Professor Spencer Kimball).

53. Capitalization on purchaser ignorance as a device to raise profit margins was focused on by Professor Tibor Scitovsky in his article *Ignorance as A Source of Oligopoly Power*, 40 AM. ECON. REV., May 1950, at 48. According to Professor Scitovsky,

> in the ignorant market every producer finds it profitable to differentiate his product, not indeed in any objective sense of the word, but by playing on the buyer's ignorance and creating the impression in one way or another that his product is different from competing products.

Id. at 49. *See also* T. SCITOVSKY, WELFARE AND COMPETITION 402 (1951); Belth & Maxwell, *The State of Competition in the Life Insurance Industry*, 15 ANTITRUST BULL. 213, 214-20 (1970); Mueller, *Sources of Monopoly Power: A Phenomenon Called "Product Differentiation,"* 2 ANTITRUST L. & ECON. REV. 59, 77-88 (1969).

In reflecting on the critics' claims, it should be borne in mind that a marketplace which may present to the critics a serious deviation from true competition (defined as price differentiation) may seem to the business executive to be highly competitive. *See* Bauer & Geyser, *The Dialogue That Never Happens*, in CONSUMERISM: SEARCH FOR THE CONSUMER INTEREST 59, 69-91 (Aaker & Day eds. 1971). The authors seek to explain why businessmen and their critics "talk past each other when discussing ostensibly the same marketplace." They decide that much of the problem revolves around vocabulary. In the case of "competition," they report that the executive focuses on product differentiation while the critic thinks in terms of price competition. Kotler has observed that many business executives view price as one of the less important concerns in the effective marketing of their products. P. KOTLER, *supra* note 2, at 514 & n.1.

B. *State Regulation of Insurance Pricing*

1. The Basic Orientation of State Regulation

In assessing the effectiveness of state regulation of life insurance pricing, it should first be recognized that Congress left regulation of the insurance industry largely up to the states under the McCarran-Ferguson Act.[54] The Act generally restricts federal intervention into the insurance field to areas where state regulation is lacking.[55] State insurance regulation has traditionally been far less concerned with policing such matters as price disclosure, expense levels, and commission structures than with protecting the overall fiscal stability of regulated companies.[56] The very logical reason for this solvency orientation is that, "if nothing else, insurance must *insure*."[57] Of course, this does not mean that pric-

54. 15 U.S.C. §§ 1011-15 (1970).

55. *Id.* § 1012. The Act was adopted to offset the effect of the Supreme Court's 1944 ruling in United States v. Southeastern Underwriters Ass'n, 332 U.S. 553 (1944). In that case the Court overruled prior precedent and held the business of insurance to be commerce under the Commerce Clause of the Constitution. *See* FTC v. Travelers Health Ass'n, 362 U.S. 293, 299 (1960) (describing the background of the Act).

56. In conjunction with its study of variable life insurance, the SEC's Division of Investment Management Regulation examined sales load restrictions applicable to life insurance. *See generally* VLI STAFF REPORT, *supra* note 14. The staff reported finding limits on sales expenses in only three states, Illinois, New York, and Wisconsin. *See* ILL. REV. STAT. ch. 73, § 856 (1973); 27 N.Y. INS. LAW § 213 (McKinney 1966); WIS. STAT. §§ 206.26-31 (1957). The New York scheme is the most intricate and exacting, limiting the first year commissions that may be charged by domestic companies or foreign companies doing business in New York to 55 percent of the premium. New York interprets its statute to have extraterritorial effect, meaning that companies selling in New York are bound to the limit on out-of-state sales. Salesperson expense and other reimbursements, together with commissions, can legally aggregate 96 percent of the first year premium, however. VLI STAFF REPORT at 142 n.3. On top of this, the New York limitation is being made increasingly less significant by the tendency of companies to establish subsidiaries to handle the New York business. *Id.* at 139 n.3; Post-Hearing Memorandum of the Mutual Fund Group 55, In the Matter of American Life Insurance Association of America Before the Securities and Exchange Commission, Aug. 21, 1973, SEC File No. 4-149; Meyer, *Accounting Change Enables Life Insurers to Pay Out Agent Fees Over Fewer Years*, Wall Street J., Mar. 6, 1973, at 8, cols. 2-3. Expense regulation in Illinois does not prevent first-year sales commissions of 100 percent of the premium paid. The Illinois and Wisconsin efforts at expense regulations have been criticized as "so liberal as to be meaningless." Written statement of John C. Bogle before Hearings on Life Insurance of the Senate Subcomm. on Antitrust and Monopoly, Feb. 23, 1973, at 5, copy on file with the *South Carolina Law Review*.

57. Kimball, *supra* note 50, at 480. Kimball isolates three solvency-related objectives of insurance regulation governing the internal operation of the insurance business: the establishment of an adequate insurance fund, the preservation of the fund's integrity, and the distribution of the fund to satisfy the needs it was created to meet. *Id.* at 480-81. For other discussions of the solvency orientation of state life insurance regulation, see S.

ing practices are not important subjects of regulatory attention. It has been claimed that "one major objective of insurance regulation [is] protection of consumers against unreasonably high prices."[58] However, while the National Association of Insurance Commissioners has adopted a model regulation that fixes a "controlling" or "maximum" premium level to limit total premiums payable in the sale of *variable* life insurance,[59] Wisconsin is presently the only state in the nation with legislation specifically designed to limit premium levels in the sale of regular individual life insurance.[60] The restraint imposed by that statute has been judged "so liberal that it is doubtful if it has ever had any effect."[61] Thus, for the present, any practical check on prices must come from competition.

KIMBALL, INSURANCE AND PUBLIC POLICY 6-7 (1960); D. MCGILL, LIFE INSURANCE 776-77 (1967).

58. Kimball & Rapaport, *supra* note 47, at 1025.

59. NAIC MODEL VARIABLE LIFE INSURANCE REGULATION, art. IV, § 2j (as adopted with technical amendments Dec. 3, 1974) [hereinafter cited as MODEL VLI REGULATION]. The Model VLI Regulation is reprinted in full in 1 NAIC PROCEEDINGS 761 (1975). The effect of section 2j is to require insurers to provide higher cash values to policyholders if the maximum premium level is exceeded. Additional reserves would be needed to back up the cash values. The NAIC has observed that the "additional cash values [required by section 2j if premium ceilings are passed] are sufficiently costly to the insurer that it will be greatly discouraged from setting its rates in excess of the maximums set forth." NAIC, Comments and Memorandum Concerning Proposed Amendments to Rule 3c-4 Under the Investment Company Act of 1940 and Rule 202-1 Under the Investment Advisor's [*sic*] Act of 1940 in Response to Investment Company Act Release No. 8216, at 57 (1974), SEC File No. 4-149 [hereinafter cited as NAIC VLI Comments].

It appears that the ceilings specified in section 2j are not very demanding. In 1974 the SEC held hearings into the regulation of variable life insurance. *See* SEC Investment Company Act Release No. 8216 (Investment Advisers Act Release No. 399) (Jan. 31, 1974) (giving notice of the hearings). At the hearings two tables were introduced by the SEC staff to show the effect of the NAIC limits. The first table, designated SEC Exhibit 3, analyzed a variable life insurance policy proposed for sale by a subsidiary of a large life insurance company. The projected sales expenses for the policy were shown to equal roughly forty percent of the premiums over the first five years of the policy, and nearly one-fourth of the premiums over the first ten years. The second table, SEC exhibit 4, projected an average sales expense of over 50 percent for the first 5 years and over 40 percent for the first 10 years by (1) using the expense and lapse assumptions embodied in the proposed policy analyzed in exhibit 3, (2) increasing the premium to the maximum limit permitted by section 2j, and (3) assuming the increase in premium was used to pay additional sales expenses.

60. WIS. STAT. § 206.26 (1957).

61. Kimball, *supra* note 50, at 492. Professor Kimball's observations, made in 1961, still appear to be valid. *See* Letter from S.C. DuRose to John P. Freeman, Sept. 8, 1975 (stating that the Wisconsin statute is "unique" and that section 206.26 "seldom, if ever, acts to limit life insurance premium levels [since] the ceiling that is established seems to be somewhat higher than the voluntary market").

2. "Intrabrand" Price Competition

There are two sides to the price competition question as it relates to individual life insurance marketing. The first concerns the extent to which a prospective policyholder is free to shop among agents for the best premium price for a given type of coverage issued by a given company ("intrabrand competition"). The other side of the question relates to the shopper's ability to make a informed choice between like coverages issued by competing companies ("interbrand competition"). The first of these two forms of possible price competition supposedly is forbidden under the terms of the Model Unfair Trade Practices Act which has been adopted in substance in nearly every state.[62]

The act makes illegal various unfair methods of competition and unfair and deceptive acts and practices in the business of insurance.[63] Among the practices proscribed by the act is

> [m]aking or permitting any unfair discrimination between individuals of the same class and equal expectation of life in the rates charged for any contract of life insurance . . . or in the dividends or other benefits payable thereon, or in any other of the terms and conditions of such contract.[64]

The law contemplates a policy pricing system responsive to objective risk evaluation with like risks paying like premiums. The aim is that, as nearly as possible, each insured ends up carrying only the cost of his or her own insurance.[65]

The act generally has been interpreted as freezing prices within risk zones, making it impractical to price shop among agents for a given policy written by a given company.[66] However,

62. *See* R. KEETON, *supra* note 46, at 539.

63. Discussions of certain unfair trade practices engaged in by life insurance agents are set forth in *Life Insurance Hearings*, pt. 3, at 2074 (draft article by Joseph M. Belth entitled *Deceptive Sales Practices in the Life Insurance Business*); Kimball & Jackson, *The Regulation of Insurance Marketing*, 61 COL. L. REV. 141, 143-65, 185-98 (1961); *cf.* Whitford & Kimball, *Why Process Consumer Complaints? A Case Study of the Office of the Commissioner of Insurance of Wisconsin*, 1974 WIS. L. REV. 639, 691-96 (analyzing agent misconduct complaints).

64. MODEL UNFAIR TRADE PRACTICES ACT § 4(7)(a), *reported in* 1 NAIC PROCEEDINGS 493 (1972) [hereinafter cited as MODEL UNFAIR TRADE PRACTICES ACT], *discussed in* Kimball & Jackson, *supra* note 63, at 144-52.

65. D. McGILL, *supra* note 57, at 774.

66. This is not to say that the shopping among insurance agents for the best possible price might not pay off economically. The practice of giving commission rebates is said

neither the antidiscrimination section nor the section prohibiting rebates of commissions[67] has stopped a number of life insurers from giving employees an opportunity to purchase policies at cut-rate prices.[68] The policies are sold directly to the employees by the companies rather than through the insurers' sales forces, with the lower price made possible because no salesperson is involved. Sales commissions are either eliminated or returned in whole or in part to the purchasing employees. It seems plain that no unfair trade practice is involved in the discount sales since any discrimination that is involved is not "unfair," but rather rational. The savings which lead to the price differential arise simply from nonpayment of a charge for personal sales attention which the employees do not want and may not need. Discrimination thus results only because the customer who benefits from personal attention pays for the service, while a self-motivated employee-customer who chooses to forego that benefit saves money.[69] This is not unfair.

---

to be commonplace in the insurance industry even though rebates are banned by the Model Act. *See* Kimball & Jackson, *supra* note 63, at 146-49, 186-87.

67. Section 4(8)(a) of the Model Unfair Trade Practices Act prohibits:

> Except as expressly provided by law, knowingly permitting or offering to make or making any contract of life insurance . . . other than as plainly expressed in the contract issued thereon, or paying or allowing . . . as inducement to such insurance . . . any rebate of premiums payable on the contract . . . or any valuable considerations or inducement whatever not specified in the contract . . . .

68. This fact came to light as a result of some investigative work done by Professor Joseph Belth of the University of Indiana's Graduate School of Business. Tennessee's insurance commissioner recently claimed that the employee discounts violate several sections of the Tennessee Code outlawing unfair discrimination and rebates. *See* TENN. CODE ANN. §§ 56-1204, 56-1214 (1968). The Commissioner's action is described in *Pandora and the Tennessee Volunteers*, 1 INS. FORUM, Nov. 1974, at 1. Upon learning of the Tennessee Commissioner's ruling, Professor Belth sent a questionnaire by certified mail to the presidents of 60 companies — all life insurers with more than $3 billion of ordinary insurance in force at the end of 1973, and to all Tennessee companies with at least $100 million of ordinary business in force at that time. Professor Belth asked the companies whether they gave preferential treatment to employees in individual life insurance purchases. Eleven companies responded that they did not offer discounts. Ten companies responded that they did offer discounts. Thirty-six companies did not make any response to the questionnaire, and three companies (not identified) responded in confidence. The companies are identified by name (with the three confidential-reply companies lumped with non-respondents) in *A Report on Employee Discounts*, 2 INS. FORUM, July 1975, at 2-3.

69. Establishing the propriety of discounts in the face of the unfair discrimination statutes is not equal to legitimization, however, since rebates of premiums are specifically prohibited. It has been stated that: "If the alleged rebate is a cash repayment or a reduction in price, it is clearly within the thrust of the Unfair Trade Practices statutes

Nevertheless, insurers' practice of permitting their employees to purchase life insurance directly from the company at cut-rate prices has been challenged as violative of the Unfair Trade Practices Act by Tennessee's insurance commissioner.[70] The Tennessee Commissioner's declaration that employee discounts are illegal and must cease has the obvious effect, if not the intent, of protecting commission income for the industry's sales force. In the past sales personnel have been quick to challenge marketing innovations that threaten commissions,[71] and it is interesting to note that the Tennessee Commissioner's statement followed close on the heels of a speech critical of the discounts delivered by a Memphis, Tennessee insurance agent who was serving as president of the National Association of Life Underwriters.[72]

There is ample precedent for rejecting claims that employee

---

whatever the amount." Kimball & Jackson, *supra* note 63, at 187. The rationale for the antirebating laws (apart from the protection given to agents' commissions) is that they protect against unfair discrimination. *See, e.g.*, McDowell v. Good Chevrolet-Cadillac, Inc., 397 Pa. 237, 242-43, 154 A.2d 497, 500 (1959); 5 G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 30.49, at 564 (2d ed. R. Anderson 1960); W. VANCE, HANDBOOK ON THE LAW OF INSURANCE 50 (3d ed. B. Anderson 1951). Thus, the same argument can be made against application of antirebating laws to discounts which pass on savings due to marketing efficiencies as was made against the applicability of the general prohibition against unfair discrimination to such discounts.

Additional support for the view that the Unfair Trade Practices Act should not be read to prohibit marketing practices that lead to cost savings is found in section 8(b) of the act. That subsection provides in part that neither the antidiscrimination nor the antirebating provisions should be construed to prohibit

> making allowances to policyholders [of policies issued on the industrial debit plan] who have continuously for a specified period made premium payments directly to an office of the insurer in an amount which fairly represents the saving in collection expenses . . . .

70. *See* note 68 *supra*. It should be noted that in Massachusetts and Virginia discounts to employees are permitted by statute. See MASS. GEN. LAWS ANN. ch. 175, § 184 (1972); VA. CODE ANN. § 38.1-52 (1973). Also, it has been reported that the insurance departments of Indiana, New York, North Carolina and Vermont have approved employee discount plans. See *A Report on Employee Discounts*, 2 INS. FORUM, July 1975, at 3. Further, the vice president of a company domiciled in Tennessee has stated that his company at one time offered an employee discount plan that had been "cleared with the attorney for the [Tennessee] Insurance Department." *Id.* at 4. The same executive took the position that "there is good legal authority that the giving of discounts to insurance company employees does not violate the statutes." *Id.*

71. *See, e.g., Life Insurance Hearings*, pt. 2, at 810 (testimony of Theodore Fuller) (discussing the impact of the "organized opposition" by "the agency system of life insurance in Connecticut" on the growth and development of savings bank life insurance in that state); text accompanying note 73 *infra* (dealing with a legal challenge by sales personnel to the mass marketing efforts of a casualty insurer in Washington).

72. *See Pandora and the Tennessee Volunteers*, *supra* note 68, at 1.

discounts are illegal. In *Independent Insurance Agents & Brokers v. Herrmann*,[73] Washington's Supreme Court considered and rejected arguments by insurance sales personnel aimed at blocking a company's application for the "mass marketing" of casualty insurance. In so ruling the court made two key points. The first was that Washington's Unfair Trade Practices Act did not make all discrimination illegal—only unfair discrimination. Second, the court ruled that unfair discrimination does not result when a company shares the benefits of marketing efficiencies with the public by passing on cost savings to customers in the form of lower rates.

Additional support for the position that such discrimination is not unlawful is available from an analogy to marketing practices in the mutual fund industry. Mutual fund marketing takes place in the shadow of a statute interpreted by the SEC to prohibit unfair discrimination in the sale of mutual fund shares.[74] The SEC has ruled that the antidiscrimination reach of the statute does not extend to discount sales to employees or officials of a mutual fund nor to its investment adviser or principal underwriter.[75] Additionally, as is discussed in detail later, the SEC has

---

73. 79 Wash.2d 462, 486 P.2d 1068 (1971).

74. The statute is section 22(d) of the Investment Company Act of 1940, 15 U.S.C. § 80a-22(d) (1970). Less than a year after the enactment of section 22(d), the General Counsel of the SEC interpreted section 22(d) as depriving a principal underwriter of authority

> to discriminate between purchasers of like amounts of redeemable securities. At least one of the purposes of the requirement [of the section] is to prevent such discrimination between investors.

SEC Investment Company Act Release No. 89 (Mar. 13, 1941). Evidence of the parallelism between the antidiscrimination reach of section 22(d) and state unfair practices legislation comes in the form of an argument made by the American Life Insurance Association in the course of trying to obtain exemption from section 22(d) for variable annuities. In arguing for exemption, the trade association indicated that section 22(d) was not necessary for the protection of investors since life insurers are covered by state antidiscrimination provisions. *Cf.* Statement of American Life Insurance Ass'n, Feb. 2, 1973, at 14 & n.21, SEC File No. 4-164. The ALIA noted in the course of its argument that:

> The variation in the [mutual fund] sales load is justified [in the case of sales to employees or organized groups] because of the differences in distribution costs, so that preferential treatment for certain groups is neither arbitrary nor inequitable.

Id. at 11. This parallelism between section 22(d) and insurance antidiscrimination statutes was recognized in the SEC staff's recent study of section 22(d) and mutual fund distribution which recommended exemption of variable annuities from section 22(d). *See* DISTRIBUTION REPORT 102 n.4. The Commission has since adopted a rule to exempt variable annuities from section 22(d) under certain circumstances. SEC Investment Company Act Release No. 8878 (Aug. 7, 1975).

75. *See* 17 C.F.R. § 270.22d-1(i) (1975).

acted to allow group discounts as an aid to the mass marketing of fund shares, and an SEC proposal that mutual fund shareholders have the privilege of purchasing fund shares at discount prices is now pending.[76] It is worth noting that recent SEC action to expand the availability of group discounts was taken in the face of industry objections citing "problems of suitability, discrimination and 'disorderly distribution.'"[77] The Commission's staff swept aside these claims, reasoning that "the core of the industry's objections" was the fear that the broad availability of group discounts "might discourage retailers from making an effort to sell fund shares on an individual basis."[78]

Those who argue that discounts to life insurance customers violate the Unfair Trade Practices Act should be required to explain why it is unfair to pass on cost savings to specific classes of customers in the form of lower prices.[79] Though this price-cutting practice may involve rebating, a discount that reflects cost savings arising from efficiencies in distribution is arguably not a type of rebate the act was meant to prohibit.[80] At the very least, it seems plain that the insurers must be prepared to budge: if cut-rate sales to employees are unlawful, then they must cease; if such sales are lawful, then it is time for the industry to consider expanding the benefit of cost savings to some attractive target markets, including existing policyholders. Mass marketing policies at discount prices to existing policyholders could generate substantial cost savings. It has been estimated, for example, that "51 percent of all Prudential [life insurance] policies sold [in 1974] were sold to individuals who already had Prudential insurance."[81]

It goes without saying that there may be valid business reasons why a life insurance company might choose not to offer price discounts to its home office employees, policyholders, or any

76. *See* notes 331-46 *infra* and accompanying text.

77. DISTRIBUTION REPORT 90.

78. *Id.*

79. It is worth noting that the act by its terms prohibits only unfair discrimination within *classes* of individuals. *See* text accompanying note 64, *supra*. A plausible answer to critics of special rates for employees, policyholders, or other groups for which distribution economies exist, is that those groups are separate classes of customers and are entitled to special rates under the law.

80. *See* note 69 *supra*.

81. Letter from John J. Murphy, Associate Director of Advertising for the Prudential Insurance Company of America, to John P. Freeman, Oct. 7, 1975.

other group. One major reason might be concern over alienating the company's sales force. But while there may be *business* reasons for denying discounts, it is debatable whether the Unfair Trade Practices Act furnishes a valid *legal* justification for prohibiting discounts where price differences reflect efficiencies in distribution. In short, it seems possible that the law allows significantly more intrabrand price variation than presently exists. A case can be made that companies — and even individual retailers — should be free to pass on to their customers savings realized through marketing efficiency. If the law does not presently permit this, then it may be time to consider new legislation to allow cost reductions. Meanwhile, those who debate the reach of the Unfair Trade Practices Act in the marketing of life insurance should keep in mind that a chief purpose of the act is to protect consumers from *unfair* practices, not to ensure maximization of sales force income.

3. "Interbrand" Price Competition — The NAIC Model Regulation

a. *Background*. In contrast with the intrabrand price shopping situation, there is no claim of legal barriers to effective price competition at the interbrand level. The paucity of regulatory restraints on price levels indicates a commitment to leave the policing of policy costs to the forces of competition. However, as was indicated earlier, companies active in the individual life insurance market have generally elected to compete solely on the basis of brand image and other nonprice factors. This reluctance to highlight price disparities has precipitated a call for regulatory attention to the need to increase the caliber of price competition in the life insurance marketplace. That attention has been forthcoming.

In a sense the life insurance disclosure "movement" is a byproduct of the war in Vietnam. In 1968 Senator Phillip Hart was attracted to the issue of life insurance cost disclosure by the unwillingness or inability of the Veterans Administration to supply cost data to discharged servicemen who had the privilege of converting the special low-cost term coverage they had acquired during their military tours into regular life insurance policies.[82] Later

82. *See* 121 CONG. REC. S 11,975 (daily ed. July 8, 1975) (remarks of Senator Hart discussing the genesis of his interest in life insurance marketing). For a detailed discussion

that year Senator Hart delivered a speech before the Legal Section of the American Life Convention. He referred to "the problems of returning Vietnam veterans" as the issue that focused his attention on life insurance disclosure[83] and then went on to warn the life insurers to "start supplying [cost] information. If not—watch for truth in life insurance to follow truth in packaging and truth in lending through the legislative mill."[84]

As a direct result of Senator Hart's admonition, a special "blue-ribbon" committee was appointed to report to three industry associations on life insurance cost disclosure.[85] The committee published a report in 1970 analyzing cost disclosure methodology in which 10 different cost comparison methods were studied. The committee's report concluded that although "no completely satisfactory method [of life insurance cost comparison] has been advanced or is likely to be," means were available to improve the level of cost disclosure in the individual life insurance market.[86] Specifically, the committee recommended an interest-adjusted method of cost disclosure as a "practical improvement" over the so-called "traditional method" of life insurance cost calculation.[87] Both methods perform the same basic task—presenting net charges (premiums less dividends, if any) minus any cash surrender value for a certain period. The result can be expressed as a lump sum dollar amount, an average cost per year, or cost per

---

of Senator Hart's dealings with the Veterans Administration, see Belth, *supra* note 40, at 1057-59. It has been intimated that Senator Hart's interest in the military insurance situation was prompted by Professor Belth. Kappes, *Life Insurance Cost Comparisons: A Scenario for the Surging Seventies*, in AMERICAN LIFE INSURANCE ASS'N, 1973 PROCEEDINGS OF THE LEGAL SECTION 57, 69. Professor Belth has confirmed that he brought the Veterans Administration situation to Senator Hart's attention. Telephone conversation with Joseph M. Belth, Sept. 19, 1975.

The issue of affording veterans useful life insurance cost data is presently under study by the Senate's Committee on Veterans' Affairs. That committee has before it S. 2218, 94th Cong., 1st Sess. (1975), introduced on July 29, 1975 by Senator Stone of Florida. For Senator Stone's remarks outlining the purposes of the legislation, see 121 CONG. REC. S 14,381 (daily ed. July 30, 1975).

83. *See Hart Warns of "Truth in Life Insurance" Bill*, National Underwriter, Oct. 26, 1968, at 15, col. 1 (Life ed.).

84. *Id.*

85. *See Life Insurance Hearings*, pt. 1, at 693 (written statement of E.J. Moorhead); Kappes, *supra* note 82, at 69. Both sources indicate the study was a direct result of Senator Hart's speech.

86. REPORT OF THE JOINT SPECIAL COMMITTEE ON LIFE INSURANCE COSTS 20 (1970).

87. *Id.* at 20-21. The traditional net cost method and the interest-adjusted method are explained in Kimball & Rapaport, *supra* note 47, at 1038-41.

year per $1000 of insurance. The chief advantage of the interest-adjusted method is that it accounts for the time value of money. The traditional method fails to do so and can thus lead to the anomaly of showing a negative cost paid for insurance over a period of time.[88]

Building on the special committee's study, a Cost Comparison Task Force was organized in late 1971 by the National Association of Insurance Commissioners (NAIC) at the urging of Wis-

---

88. Consider, for example, *What's the Real Cost of Life Insurance?*, AIDE, Winter 1975, at 20, setting forth this hypothetical:

> A $10,000 Whole Life Policy was issued to a male age 35. The annual premium is $240. The total of dividends paid annually to the insured is $1500 by the end of the 20th year. Cash surrender value at the end of 20 years is $3610.
>
> Older [Traditional] Method
>
> Here is the arithmetic used to develop cost per year of $1000 of insurance:

Total Premiums, 20 years	$4800.00
Subtract dividends, 20 years	1500.00
Net premiums, 20 years	$3300.00
Subtract cash value, 20 years	3610.00
Insurance cost	$ 310.00
For average cost per year divide by 20	$ 15.50
For cost per $1000 per year divide by 10	$ 1.55

The yearly cost per $1000 at the end of 20 years for the same policy with a 4 percent interest assumption was calculated to be $5.88. *Id.* at 21.

It should be noted that some low cost companies may be able to show a negative cost even if an interest assumption is used to make cost calculations. A policy disclosure statement prepared by Teachers Insurance & Annuity Association of America for a $25,000 participating whole life policy issued to a 30-year old male in 1976 lists a 20-year interest-adjusted cost figure of -$.27 per year per $1000. The calculation was based on a four percent interest assumption. A copy of the disclosure statement is on file with the *South Carolina Law Review.*

For a demonstration showing how the use of an interest assumption can alter the relative rankings of companies based on cost, see Statement of Joseph M. Belth before the SEC, May 12, 1972, *reprinted in Life Insurance Hearings*, pt. 1, at 545, 549. Ten companies were ranked according to twenty-year net costs per $1000 on $25,000 participating policies issued in 1970 to men aged 35. Based on the traditional net cost method, Phoenix Mutual ranked first (lowest) in the standings with a cost per $1000 of -$3.46. Bankers Life (Iowa) was seventh with a cost of -$2.21. When a five percent interest assumption was added to the compilation, the two companies switched places in the standings. Bankers Life's interest-adjusted net cost was $5.49; Phoenix Mutual's was $6.34. For a study of consumers' reactions to the traditional and interest-adjusted cost comparison method, see LIFE INSURANCE MARKETING & RESEARCH ASS'N, CONSUMER'S REACTIONS TO LIFE INSURANCE POLICY COST COMPARISON METHODS (1975). The study reports that consumers surveyed questioned the "credibility" of a negative cost derived through calculations by the traditional method. Also, the interest-adjusted method was preferred over the traditional method, and three of four respondents supported the idea of "improved, standardized cost information." *Id.* at 32.

consin's former Insurance Commissioner, Stanley C. DuRose.[89] At that time Commissioner DuRose informed the NAIC that he was in the process of implementing in Wisconsin proposed rules governing deceptive sales practices and cost disclosure.[90] The Wisconsin rules were subsequently promulgated in 1972,[91] thus becoming the first set of regulations mandating cost disclosure in individual life insurance sales. Seeking to improve upon the Wisconsin regulation, the NAIC Task Force commissioned a set of 12 research projects to gather data on disclosure techniques and their usefulness in satisfying consumers' needs.[92] Following review of the research reports generated by the projects and numerous meetings with industry representatives, the NAIC adopted a Model Life Insurance Solicitation Regulation at its December 1975 meeting.

89. *See* Gardner Address, *supra* note 30, at 20.

90. *Id.*

91. *See* WIS. AD. CODE §§ INS 2.14-15 (1974), *discussed in* Kimball & Rapaport, *supra* note 47, at 1036-41; *Life Insurance Hearings*, pt. 2, at 916-17, 955-56, 973 (written statement and testimony of S.C. DuRose).

92. The different research project reports are as follows: *Life Insurance Hearings*, pt. 4 (project 1; production of life insurance cost data base); SOCIETY OF ACTUARIES, ANALYSIS OF LIFE INSURANCE COST COMPARISON INDEX METHODS (1974) (projects 2 & 9); E. MOORHEAD, "SNAPSHOT" AND "AVERAGE" APPROACHES TO POLICY COST COMPARISON (1975) (project 3); LIFE INSURANCE MARKETING & RESEARCH ASS'N, CONSUMER'S REACTIONS TO LIFE INSURANCE POLICY COST COMPARISON METHODS (1975) (project 4); AMERICAN LIFE INSURANCE ASS'N, MARKET CHARACTERISTICS AND THEIR EFFECT UPON LIFE INSURANCE COST COMPARISON METHODS (1974) (project 5); AMERICAN LIFE INSURANCE ASS'N, DIVIDEND ILLUSTRATIONS: A COMPARISON OF ILLUSTRATED AND ACTUAL DIVIDEND RESULTS (1974) (project 6); SOCIETY OF ACTUARIES, PHILOSOPHIES IN THE COMPUTATION AND DISSEMINATION OF DIVIDEND ILLUSTRATIONS (1974) (project 7); AMERICAN LIFE INSURANCE ASS'N, THE "MISUNDERSTANDING" ISSUE: COST DISCLOSURE IN THE SALES ENVIRONMENT (1974) (project 8); INSTITUTE OF LIFE INSURANCE, THE NATURE OF THE WHOLE LIFE CONTRACT (1974) (project 10); LIFE INSURANCE MARKETING & RESEARCH ASS'N, LIFE INSURANCE CONSUMER: A REVIEW OF THE LITERATURE (1973) (project 11, phase 1); INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE CONSUMERS: AN EXPLORATORY STUDY OF ATTITUDES AND EXPECTATIONS REGARDING COST COMPARISON (1974) (project 11, phase 2); INSTITUTE OF LIFE INSURANCE & LIFE INSURANCE MARKETING & RESEARCH ASS'N, LIFE INSURANCE CONSUMERS: A NATIONAL SURVEY OF COST COMPARISON ATTITUDES AND EXPERIENCE (1975) (project 11, phase 3); E. MOORHEAD, THE "MANIPULATION" ISSUE (1975) (project 12). The topics explored by the various research projects are outlined in *Life Insurance Hearings*, pt. 4, at 2231-32. Some of the key findings of the research projects are collected in NAIC LIFE INSURANCE COST COMPARISON (C3) TASK FORCE, SUMMARY OF THE CONCLUSIONS AND MESSAGES SUGGESTED BY THE REPORTS ON THE TASK FORCE RESEARCH PROJECTS (1975).

Together with state and federal inquiries into the policies and practices of the life insurance industry, the research project reports evince the most searching scrutiny of the life insurance industry since the Armstrong Committee investigation some 70 years ago. For background concerning the Armstrong Committee, its report, and the aftermath, see J. STALSON, MARKETING LIFE INSURANCE 548-54 (McCahan Found. ed. 1969).

b. *Coverage*. The announced purpose of the Model Regulation

> is to require insurers to deliver to purchasers of life insurance, information which will improve the buyer's ability to select the most appropriate plan of life insurance for his needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration, and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance.[93]

Toward those ends, the Model Regulation requires, subject to some limited exceptions for special types of policies,[94] that buyers of life insurance must be furnished useful information in three different forms. First, prospects must be furnished with a narrative discussion of basic facts about life insurance in the form of a "buyer's guide." This guide is intended to educate consumers and thereby improve the ability of prospects to select the most appropriate plan of life insurance for their needs. The concept of the guide was approved by the NAIC at its 1975 meeting with the understanding that the language of the guide subsequently would be revised to achieve readability at the eighth grade level.[95] When finalized, the guide will set forth basic information about life insurance, including discussions of: the three basic types of life insurance (endowment, whole life and term), participating and non-participating policies, types of insurance companies (stock and mutual), how to determine the need for life insurance, and how to compare life insurance costs by use of interest-adjusted cost indexes.

The second type of disclosure made mandatory by the Model

93. NAIC MODEL LIFE INSURANCE SOLICITATION REGULATION § 2(A) (1975) [hereinafter cited as MODEL REGULATION].

94. *Id.* § 3(B) exempts from the regulation's coverage:

1. Annuities.
2. Credit life insurance.
3. Group life insurance.
4. Life insurance policies issued in connection with pension and welfare plans as defined by, and which are subject to, the federal Employee Retirement Income Security Act of 1974 (ERISA).
5. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

95. The guide's text is set forth in the appendix to the Model Regulation. Distribution of the guide to prospects is made mandatory by section 5 of the Model Regulation, and the timing of disclosure is prescribed by section 5(A).

Regulation requires that consumers be given a "policy summary" designed to improve the buyer's understanding of the basic features of the policy in question.[96] The summary, which must consist of a separate document, requires identification of such things as the name and address of the salesperson (if any); the name and address of the company;[97] the nature of the policy and riders; and detailed disclosure concerning annual premiums (separately stated for the basic policy and riders), guaranteed death payments, cash surrender values, cash dividends payable (including a statement that dividends are not guaranteed), and guaranteed endowment amounts. Also required in the policy summary are the effective policy loan annual percentage interest rate, and cost indexes. Additionally, the Model Regulation requires that the summary include a legend "in close proximity" to the cost indexes informing the consumer that an explanation of how to use the indexes is set forth in the buyer's guide.[98] It is anticipated that most companies will produce the required financial data by computer.[99]

The life insurance cost indexes that are included in the policy summary furnish the insurance buyer with the third type of relevant information made available by the Model Regulation. Two indexes are required: the surrender cost index[100] and the premium

96. *See* MODEL REGULATION § 4(F).

97. At the Life Insurance Hearings it was noted that it "sounds humorous" to require disclosure of the company's name, but that "this is an aspect which is sometimes overlooked." *Life Insurance Hearings*, pt. 2, at 960 (testimony of S.C. DuRose).

98. MODEL REGULATION § 4(F)10. When the MODEL REGULATION was approved by the NAIC in its December meeting, the door was left open to adding one more piece of information to the policy summary. The additional disclosure would be figures representing the policy's "equivalent level annual dividend" as of years 10 and 20. The size of the equivalent level annual dividend would be calculated by accumulating dividends for the pertinent period at five percent and dividing the result by the accumulated amount of $1 per year at five percent. The purpose of an equivalent level dividend disclosure is to allow the buyer to distinguish between guaranteed cost and cost illustrations which include dividends. An equivalent level dividend figure was required in the Nov. 17, 1975, draft of the MODEL REGULATION. It was deleted when its chief proponents, mainly stock insurance companies, failed to put forth evidence that the disclosure is worth the added complexity it introduces into the cost disclosure matrix. The NAIC's action to allow reconsideration gives proponents of the equivalent level dividend a second chance to argue for its inclusion. A decision on whether to require the disclosure will likely be made by the NAIC's Executive Committee in the spring of 1976.

99. Statement of the Honorable William H. Huff, III, President, National Association of Insurance Commissioners, submitted to the Senate Subcomm. on Housing and Insurance, Dec. 3, 1975, at 10.

100. The surrender cost index is defined in section 4(E)1 of the MODEL REGULATION.

outlay index.[101] Both provide for cost disclosure on an interest-adjusted basis using a five percent interest assumption.[102] Both relate a price per year per $1000 of the face amount as of the 10th and 20th years of the policy. The surrender cost index is derived by deducting the cash surrender value for the pertinent period and interest-adjusted dividends, if any, from premiums. The resulting index measures the relative cost of protection assuming that the policy was surrendered at the end of ten or twenty years. There are several assumptions built into the index: (1) that the insured will survive and keep the policy in force long enough to surrender it; (2) that dividends, if any, will be declared according to the company's current dividend scale; and (3) that the value of the policy at the 10th and 20th years is the cash value at those times. Given these assumptions, the lower the surrender cost index, the lower the cost of insurance. The premium outlay index is calculated in the same manner as the surrender cost index but without using cash value in the calculation;[103] it thus produces a

101. This index is defined in section 4(E)2 of the MODEL REGULATION.

102. A five percent figure for making interest adjustments was recommended in Kimball & Rapaport, *supra* note 47, at 1030. A detailed discussion of the Task Force's reasoning in selecting the five percent figure is presented in Written Remarks on Behalf of the Life Insurance Cost Comparison Task Force of the National Association of Insurance Commissioners at the Hearings on S. 2218, before the Senate Subcomm. on Housing and Insurance, Dec. 3-4, 1975, at 8-10 [hereinafter cited as Task Force Remarks]. The American Life Insurance Association would have preferred a four percent interest assumption, on the ground that slight changes in the assumed interest rate do not materially affect rankings, and the four percent figure is used in regulations already adopted and in national publications showing interest-adjusted cost. Letter from Richard V. Minck to John P. Freeman, Aug. 15, 1975, at 3. The propriety of making *any* interest assumption has been criticized on the ground that it adds an artificial increase to the cost of life insurance which is not added to the cost of other goods and services. *See, e.g., The Dangers of Introducing an Interest Factor*, PROBE, Jan. 15, 1973, at 3. The rebuttal seems to be that it is more misleading not to adjust for interest. *See* Belth, *supra* note 40, at 1065-66. A discussion of the effect of an interest assumption on insurance pricing is set forth in note 88 *supra*.

103. MODEL REGULATION § 4(E)2, which defines the premium outlay index, requires that cash surrender values and terminal dividends be excluded from the calculations. The propriety of excluding terminal dividends from the index is open to question since the index serves a function as a "death index," reflecting the cost of life insurance on the assumption that the prospect died at the end of the specified period. This being the case, terminal dividends that would be payable at death should be counted in calculating cost under the index. The NAIC left open the issue of how to account for terminal dividends when it approved the Model Regulation. Authority to rule on the question was delegated to the NAIC's Executive Committee for action in early 1976. For criticism of terminal dividends as a "competitive gimmick" and argument that they deserve "very little value," in a cost disclosure system, see *Some Interesting Terminal Dividend Scales*, 2 INS. FORUM, Mar. 1976, at 3, 4.

measure of cost assuming continuation or death. Pains have been taken to make the indexes workable for a wide array of policies, including policies with death benefits that vary by duration.[104]

As the foregoing summary indicates, the Model Regulation has three distinct disclosure aspects: (1) mandatory disclosure of basic information designed to educate the prospect about the life insurance marketplace and thereby assist in the selection of a suitable purchase; (2) mandatory disclosure of key facts concerning the specific purchase transaction being engaged in; and (3) mandatory disclosure of cost data so that the (hopefully) educated prospect can shop for the most economical offering. In recognition that price shopping will require time, section 5(A) of the Model Regulation provides that prospects must either be given all mandatory disclosures before their application is taken, or else they must receive a 10-day unconditional refund ("free-look") right with all disclosures made at or prior to the time the policy is delivered.

To assist the regulation's three pronged consumer education program, section 6 requires record-keeping by companies, and full and fair disclosure to a prospect by a salesperson of his or her occupation and the companies he or she represents. The section further forbids the use of "[a] system or presentation which does not recognize the time value of money" for comparing costs,[105] and also establishes various technical requirements relative to the data disclosed. Further support for the consumer education structure of the proposal is provided in section 7 which states that the

104. According to one industry source, the failure of the June 1975 NAIC discussion draft of the Model Regulation to cover such policies was the "most significant weakness" of the draft. Written Statement of Jack T. Kvernland, Senior Vice President and Chief Actuary, Prudential Insurance Company of America, submitted to the Senate Subcomm. on Housing and Insurance, Dec. 3-4, 1975 (attachment II). The exemption of such policies in the June 1975 discussion draft was heavily criticized. *See* 121 CONG. REC. S 11,977 (daily ed. July 8, 1975) (remarks of Senator Hart); *Franklin Life's President's Plan,* 1 INS. FORUM Mar. 1974, at 2.

105. MODEL REGULATION § 6(E). It has been argued that a similar prohibition in an earlier draft of the Model Regulation did not outlaw the use of the traditional method for cost comparison purposes so long as use of that method was combined with use of the interest-adjusted method. *See* Gardner Address, *supra* note 30, at 28-29. Section 6(E) does go on to allow use of the traditional method "for the purpose of demonstrating the cash-flow pattern of the policy" so long as the presentation includes a legend explaining that the presentation overlooks the time value of money. Use of the traditional method has been outlawed in New York since January 1, 1975. *See* N.Y. INS. DEP'T REG. No. 74. (Nov. 25, 1974).

failure to furnish a prospect with a buyer's guide, policy summary and cost indexes within the time frame required by section 5(A) is an act of misrepresentation.

c. *Commentary*. "Truth in life insurance" has been characterized as "an idea whose time has come."[106] The Model Regulation embodies a commitment that goes far toward transforming the idea into reality. Though it has been upstaged to a degree by adoption of somewhat similar disclosure regulations in six states,[107] the Model Regulation still stands as a milestone. Besides giving important substantive assistance designed to help prospective policyholders understand what life insurance is and how to select a low cost policy that meets their needs, the Model Regulation has symbolic importance as well since it exemplifies a distinctly pro-consumer tilt on the part of the NAIC. This is significant because state insurance regulators as a group have been

106. Belth, *supra* note 40, at 1054. For more on this figure of speech see Kappes, *supra* note 82, at 59-61.

107. In order of date effective, the states having disclosure rules are: WIS. AD. CODE § INS 2.14, eff. July 1, 1972 (sales practices), and WIS. AD. CODE § INS 2.15, eff. Jan. 1, 1973 (interest-adjusted cost disclosure mandatory); ARK. INS. DEP'T RULE & REG. 17, eff. Feb. 1, 1974 (interest-adjusted cost disclosure required on request of applicant); CAL. INS. DEPT. RULING NO. 193, eff. July 8, 1974 (interest-adjusted figures required only when more policy detail is given than the initial premium for the first year); TEX. INS. BD. ORDER NO. 27283, eff. Sept. 15, 1974 (5-, 10-, and 20-year interest-adjusted index figures are required on request or where more policy data is given than first year's premium); N.Y. INS. DEP'T. REG. NO. 74, eff. Jan. 1, 1975 (outlaws traditional method; alternate methods are permissible so long as an interest factor, no percentage stipulated, is included); 31 PA. CODE ch. 83, eff. Dec. 10, 1975 (solicitation must be accompanied by a comprehensive disclosure statement with an interest-adjusted surrender comparison index for 10 and 20 years to be furnished on request or upon delivery of the policy). Two other states, Kansas and West Virginia, recently have adopted regulations requiring specific disclosures to be made in individual life insurance sales. *See* KAN. INS. DEP'T. RULE & REG. § 40-2-14, eff. Jan. 1, 1974; W. VA. ADMIN. REG. ch. 33-2, ser. XII, eff. Apr. 22, 1974. Neither regulation requires the disclosure of interest-adjusted cost figures.

With the exception of the Wisconsin provisions, the state rules and regulations cited above followed the lead of the NAIC. At its June 1973 meeting the NAIC adopted two model regulations dealing with life insurance solicitation. The first involved the NAIC's adoption of a model regulation covering procedures for cost disclosure by use of an interest-adjusted index. 2 NAIC PROCEEDINGS 538-40 (1973). The model regulation was adopted on an interim basis, pending the conclusions of the 12 research projects the NAIC had commissioned. Letter from S.C. DuRose to John P. Freeman, June 14, 1974, copy on file with the *South Carolina Law Review*. The NAIC also adopted on an interim basis at the mid-1973 meeting a model regulation spelling out certain deceptive practices in life insurance solicitation. 2 NAIC PROCEEDINGS 541-42 (1973). Both model regulations were patterned after the regulations promulgated in 1972 by Wisconsin's insurance commission. *See generally* Gardner Address, *supra* note 30, at 21-26.

criticized in the past for a lack of independence from the industry they regulate.[108]

The main strength of the Model Regulation lies in the realistic way it seeks to satisfy the basic needs of the life insurance marketplace. As was noted earlier, promulgation of the Model Regulation was preceded by numerous research studies. Several of the studies probed consumers' perceptions concerning life insurance. One industry source accurately summarized the significance of the findings in the following terms:

> If we learn nothing else from the research project reports, we should learn that the need is urgent to create a customer who understands. Very simply, the basic need is that the purchaser of life insurance understand the three types of life insurance available, how each of them works, and what each will do for him. Any numerical cost index is completely useless to the public if the public does not have an understanding of the product being measured or compared.[109]

The requirement of the Model Regulation for the dissemination of a buyer's guide recognizes the truth of this observation and provides a necessary supplement to the overall disclosure scheme. It was noted earlier that the buyer's guide has not yet been finalized. When it is, it probably will be criticized by two groups of people: those who think the guide's discussion is too detailed to be easily understood by the average buyer, and those who think the discussion is too superficial to be of value to the average buyer. If this is the case, then the Task Force is likely to have reached the correct result on what its chairman has called the "pivotal question of balance."[110]

---

108. *E.g.*, Denenberg, *Insurance Regulation: The Search for Countervailing Power and Consumer Protection*, 1969 INS. L.J. 271, 273-75 (observing that the quality of state insurance regulation seems to be improving, but that "[s]ometimes it can be asked who is the regulator and who is the regulated").

109. Statement of IDS Life Insurance Company to the NAIC Cost Comparison Task Force, Apr. 1975, at 2-3. Also, *see* White, *Cost Disclosure and Comparisons—The Direction of Emerging Requirements*, BEST'S REV., Aug. 1975, at 26, 28 (Life ed.):

> "[P]roduct disclosure" is much more important than "cost disclosure." This implies an educational responsibility, for both the agent and his company, far beyond what either assumes today. The average purchaser of life insurance is never going to be able to make a value judgment as to the cost or adequacy of his insurance until he has a fairly clear understanding of the life insurance product and its major variations.

110. Statement of the Honorable William H. Huff, III, *supra* note 99, at 5.

Assuming that the buyer's guide is a success, the Model Regulation will nevertheless have some weaknesses. This should hardly be surprising. Without counting the Model Regulation's disclosure scheme, there have been no fewer than 21 different attempts at balancing clarity and accuracy in life insurance cost disclosure, and each of the 21 has been found wanting in some particular.[111] The initial problem with the cost disclosure system used in the Model Regulation concerns terminology. For instance, the regulation and the buyer's guide refrain from calling the surrender and premium outlay indexes cost comparison indexes. If the indexes are for cost comparison, then the words "cost comparison" should be included in the names of the indexes. To be sure, the Model Regulation requires that an explanation of the intended use of the indexes be set forth in the buyer's guide[112] and that statements concerning the use of the indexes explain that they are useful for comparing similar policies.[113] But given this commitment, there seems no reason to "beat around the bush" over what the indexes are designed to effectuate. Failure to be direct in terminology unnecessarily dilutes the impact of the disclosure scheme.[114]

Another shortcoming of the Model Regulation is the novelty

111. *See Life Insurance Hearings*, pt. 2, at 930-34 (exhibit IV to written statement of S.C. DuRose). The exhibit describes and criticizes 21 different methods. *Id. See also* Life Insurance "Price," "Cost," and "Value" Illustrations, Address by Harold W. Baird, National Symposium on the Consumer in the Sale of Life Insurance, May 3-5, 1972, in Madison, Wisconsin, *reprinted in Life Insurance Hearings*, pt. 2, at 993-1019 (analyzing 20 methods). A recent and very thorough discussion of 10 life insurance cost comparison methods is presented in SOCIETY OF ACTUARIES, ANALYSIS OF LIFE INSURANCE COST COMPARISON INDEX METHODS (1974). The actuaries who prepared the study reported that they "found it increasingly evident that no cost comparison method can adequately take into account all the factors a buyer should consider in the purchase of a life insurance policy." *Id.* at 5.

112. *Cf.* MODEL REGULATION § 4(F)9.

113. *See id.* § 6(G).

114. *Cf. Life Insurance Hearings*, pt. 2, at 1105 (testimony of Professor Spencer Kimball) (indicating that it is "quite possible" that failure to properly title an index could lead consumers into not thinking it is a cost index). Professor Kimball went on to observe that:

> On the other hand, if an index of any sort is going to be used in the marketplace, one can be sure that the agents will use it as effectively as they can. And they will say, "Company A has an index of such and such, and my company has an index of such and such."
>
> That comparison will be the effective sales device that will be used. I think the term that is used in the regulation is of less importance.

Id.

and artificiality of comparing index numbers. The revelation that a department store uses an annual percentage rate of 18 percent to calculate finance charges is a disclosure that has meaning to many consumers. A large segment of the public would also comprehend a two-point jump in the Consumer Price Index or the closing of the Dow Jones Industrial Average at 985. In contrast, disclosure that a given policy carries a 10-year surrender cost index of $5.05 has no meaning for most of the population. Educating the public to appreciate the importance of such information will be a major task. At a later point in this article it will be shown that there are more easily understood reference points for comparing the relative cost of competing policies.

A third difficulty with the Model Regulation is its use of two different indexes in tandem instead of a single cost index. This doubles the number of comparisons that must be made in order to price shop and may lead to confusion.[115] A further potential hazard is the threat that policies will be manipulated so as to look attractive when analyzed for the two index periods.[116] Addition-

---

115. It has been noted that:

> Significant differences in relative index values may result depending on the index measure used; for example, comparisons using a cost index based on death occurring at a specified time may produce different results from comparisons using a cost index based on surrender occurring at a specified time.

AMERICAN LIFE INSURANCE ASS'N, THE "MISUNDERSTANDING" ISSUE: COST DISCLOSURE IN THE SALES ENVIRONMENT 9 (1974). The ALIA report found favor with dual disclosure of surrender and death indexes so a prospect would "be able to decide how important each of these values is to him and to choose accordingly." *Id.*, app. A at 2, 4. Since most insurance is bought for death protection, a prospect choosing between the two indexes would seem likely to put stock in the death or "premium outlay" index. However, a prospect might well judge the surrender index more important if he or she realized that studies show that a majority of policies lapse within 20 years. See *Life Insurance Hearings*, pt. 4, at 2887. "In fact, only about one-third of policyholders keep their policies until their old age." 121 CONG. REC. S 11,976 (daily ed. July 8, 1975) (remarks of Senator Hart).

116. It is claimed that companies do in fact window-dress their policies to show well in price comparisons. Belth, *supra* note 40, at 1063; Letter from Joseph M. Belth to Victor E. Henningsen, Apr. 10, 1973, at 1, *reprinted in Life Insurance Hearings*, pt. 2, at 1138. For evidence of manipulation see Written Statement of Joseph M. Belth on S. 2218 before the Senate Subcomm. on Housing and Insurance, Dec. 3, 1975, at 112-24. The NAIC Cost Comparison Task Force has taken the position that:

> The control of any manipulation of policy values in order to present a more favorable cost ranking than what is actually the case Should be achieved by regulatory action that keeps manipulated policies off the market rather than attempting to provide life insurance buyers with data sufficiently elaborate in order for the buyer to detect the manipulation.

Minutes of June 10, 1975 NAIC Life Insurance Task Force Meeting at 3.

A detailed discussion of policy manipulation is set forth in E. MOORHEAD, THE "MANIPULATION" ISSUE (1975). The author suggests that policing of manipulation be han-

ally, since chances of a policyholder dying during the chosen index periods often may be remote, it would seem sensible to require that the index period for the premium outlay index, which is in a sense a "death" index, be whatever length of time constitutes the prospect's life expectancy.[117] Another problem with the cost disclosure scheme is common to all systems using the interest-adjusted method, namely that the index method does not account for the gradual reduction in the amount of protection (face amount less cash surrender value) provided by whole life policies as the insured ages.[118]

As the foregoing discussion indicates, virtually all of the regulation's force is spent on using printed disclosures to help consumers become better insurance buyers. The theme is that better buyers will shop among companies for the least expensive alternative, thereby fostering price competition. But there is more to

---

dled by a cooperative effort among the state insurance commissioners through a central office. It is further suggested that any actuary responsible for the design of a manipulated policy be called before authorities in states where the policy is sold and asked to justify the pattern of cost and value in "terms of the buyers' rather than the company's interests." *Id.* at 10-11. For additional analysis of manipulation, see Kimball & Rapaport, *supra* note 47, at 1039, 1040 n.63.

A device already used in a variable life insurance prospectus to protect against manipulation is "attestation by actuaries that the tables are accurate reflections of the contract and that the contract was not slanted to show exceptional results for the ages chosen for the tables." Address by Mary E.T. Beach, 1976 Mutual Funds and Investment Mgm't. Conf., in Phoenix, Ariz., Mar. 9-12, 1976 2 CCH MUTUAL FUNDS GUIDE ¶ 10,258 (Mar. 1976).

117. The premium outlay index first appeared in the Model Regulation disclosure scheme in the June 10, 1975 discussion draft of the regulation. Its introduction was criticized by a representative of Northwestern Mutual Life Insurance Company at the NAIC meeting where the discussion draft was considered. The points he raised have some merit. They were:

> 1. The premium outlay index shows cost assuming death at the end of the index period. Thus, there should be some correlation to the likelihood death will occur during the period being illustrated . . . . [F]or Northwestern Mutual the average policy duration for death claims is approximately thirty-four years, a time span well in excess of the twenty-year maximum period for the index.
> 2. The short periods are unrealistic and discriminate in favor of nonparticipating policies, which will show lower cost during the early years of the policy.
> 3. If a premium outlay index is necessary, it should be done on the basis of the buyer's life expectancy.

Written statement of H. Daniel Gardner to the NAIC Task Force, June 10, 1975. *See also* Price-less Pricing: An Actuary's View of the Consumer's Dilemma, Address by Clair A. Lewis, American Risk and Insurance Association, Aug. 20, 1975, at 10-11.

118. *See Life Insurance Hearings*, pt. 2, at 1106 (testimony of Professor Spencer Kimball); Kimball & Rapaport, *supra* note 47, 1040-41; *cf.* AMERICAN LIFE INSURANCE ASS'N, MARKET CHARACTERISTICS AND THEIR EFFECT ON LIFE INSURANCE COST COMPARISON METHODS 16-19 (1974).

the life insurance marketing matrix than buyers and companies. Tens of thousands of persons make their living selling life insurance. The Model Regulation makes only one mild attempt to pressure sales personnel into helping buyers select low cost policies. The source of that pressure is the statement in the present draft of the buyer's guide that, "A good agent will be able and willing to explain the cost and coverage differences among companies."[119] Though the regulation does enunciate some specific disclosure obligations owed by sales personnel,[120] it is silent on the nature and extent of any duty owed by sales personnel to inform customers of cost differences. This is a significant shortcoming.

Arguably the Model Regulation is also weak in its attention to disclosure of sales commissions and the need for post-sale disclosure of policy information. The NAIC's model regulation dealing with *variable* life insurance requires sales commissions to be disclosed[121] and furnishes the policyholder with detailed post-sale disclosure on an annual basis to enable the policyholder "to make an informed decision as to whether he should continue the policy."[122] The NAIC has curiously taken the position that disclosure of commissions and post-sale disclosure of policy information is sufficiently important to be mandatory for variable life insurance transactions but not for regular life insurance sales.[123] On the other hand, the Model Regulation's buyer's guide includes a discussion warning buyers that early surrender of a long-term policy may be economically disadvantageous; this worthwhile caveat is not required by the variable life insurance regulation.

Another shortcoming of the Model Regulation is its failure to require companies to file cost information on their policies with state insurance departments or with the NAIC. Commentary ac-

119. MODEL REGULATION, Appendix at 10 (Dec. 1975 draft).

120. *See id.* §§ 6(B), (C).

121. MODEL VLI REGULATION, art. VII, § 4.

122. *See* NAIC VLI Comments, *supra* note 59, at 45. The requirement for post-sale disclosure is set forth in MODEL VLI REGULATION, art. IX, § 1.

123. In response to the question of whether "front-end loads" should be fully disclosed, the NAIC Task Force took the position that the policy summary provided sufficient data "to permit a reasonably accurate calculation" of the front-end load. Task Force Remarks, *supra* note 102, at 6. The justification for neglecting post-sale disclosure in the Model Regulation appears to be that the Task Force was assigned to deal only with pre-sale disclosure. *Id.* at 12. The NAIC commentary went on to question the validity of such disclosure, arguing that "[t]he information would add confusion to an already complicated premium notice." *Id.* Peculiarly, worry over confusion did not deter the NAIC from requiring the disclosure in the VLI regulation.

companying an early draft of the Model Regulation recommended that each state require insurers to submit to state authorities a comprehensive array of cost data.[124] Such a system of compulsory disclosure of data covering all policies for certain sex, age, and coverage combinations could serve a number of useful purposes. First, it would enable state regulators to identify more quickly policy forms having undesirable underlying premium, cash surrender value, and dividend structures.[125] Second, collection of price data at a central location would facilitate "one-stop" price shopping by industrious prospects. Third, the resulting data bank could make easier the consumer education tasks of journalists,[126] regulators and, most importantly, sales personnel interested in presenting to the public reliable information about product pricing in the individual life insurance market. Pennsylvania's Insurance Department has already implemented a centralized disclosure system of sorts through publication of so-called "shopper's guides,"[127] of which several million copies are now in circulation.[128] While distribution of the guides has aroused

124. *See* Proposed Report by NAIC Task Force on Life Insurance Cost Comparison and Price Disclosure (May 11, 1973 Work Draft), *reprinted in Life Insurance Hearings*, pt. 2, at 1020-21. The disclosure system that was recommended is discussed in detail in Belth, *supra* note 40, at 1062-66.

125. This was a reason given for the NAIC Task Force recommendation that the state commissioners adopt Belth's "price of protection" disclosure format. Proposed Report by NAIC Task Force, *supra* note 124, at 1021. Through use of the Belth system the Task Force discovered that "many policy forms approved for use by insurance regulatory officials contain highly undesirable underlying . . . structures." *Id.* Among the concerns of the regulators was their finding that "[c]areful analysis of some policy forms reveal that values of the policy form may reflect tontine or semi-tontine features and disguise." *Id.* Tontine and semi-tontine structures are discussed in Kimball & Hanson, *The Regulation of Specialty Policies in Life Insurance*, 62 MICH. L. REV. 167, 184-200 (1963).

126. For examples of articles focusing public attention on disparities in costs between companies, see, *e.g.*, *Life Insurance: How Costs Compare, Company by Company*, CHANGING TIMES, June 1974, at 25; *What Life Insurance Really Costs*, MONEY, Jan. 1973, at 52.

127. For discussion of, and materials concerning the Pennsylvania disclosure system, *see generally Life Insurance Hearings*, pt. 3, at 1536-40, 1583-1669. Comparably, the Michigan Insurance Department has also published a *Consumers' Guide to Life Insurance in Michigan* that sets forth comparative cost data.

128. Denenberg, *Forward* [*sic*] to PENNSYLVANIA INSURANCE DEP'T, SHOPPER'S GUIDE TO STRAIGHT LIFE INSURANCE (2d ed. 1973). According to the recently published results of a national survey, 15 percent of those sampled were aware of shopper's guides. The better educated and most heavily insured had the highest percentages of awareness, with 25 percent awareness for respondents holding postgraduate degrees, and the same awareness rating for persons having household life insurance coverage in excess of $50,000. INSTITUTE OF LIFE INSURANCE & LIFE INSURANCE MARKETING & RESEARCH ASS'N, LIFE INSURANCE CONSUMERS: A NATIONAL SURVEY OF COST COMPARISON ATTITUDES AND EXPERIENCE 22 (1975).

criticism,[129] it has been claimed that they have influenced insurers identified as "high cost" companies to withdraw their policies in Pennsylvania.[130]

Despite its deficiencies, the Model Regulation promises to have a number of positive effects on the individual life insurance market. Some speculation on the possible impact of wide adoption of the Model Regulation on consumers, agents and insurance company managements will be offered shortly. Before taking those matters up, consideration will be given to the contours of the cost disclosure scheme set forth in Senator Hart's Consumer Insurance Information and Fairness Act.

C. *Proposed Federal Price Regulation*

1. Background

The introduction of S. 2065 came nearly seven years after Senator Hart's "truth in life insurance" warning to the American Life Convention, and less than six months prior to adoption of the Model Regulation by the NAIC. The bill is aimed at achieving the same basic goal as the NAIC Model Regulation: a life insurance marketplace where consumers are better able to select suitable coverage at reasonable prices. The major provisions drafted to achieve that goal, and some key differences between those provisions and the NAIC Model Regulation are discussed below.

---

129. *See Life Insurance Hearings*, pt. 2, at 961 (testimony of S.C. DuRose); *id.* at 1094 (written statement of Professor Spencer Kimball). For a rating of the Pennsylvania guides by various state insurance commissioners see, *Life Insurance Hearings*, pt. 2, at 912.

130. Pennsylvania Insurance Department News Release, Feb. 8, 1973, *reprinted in Life Insurance Hearings*, pt. 3, at 1751. This moved Commissioner Denenberg to exclaim that "[b]eing on the highest cost list is like being on the FBI's ten most wanted list — only this time it's a ten least wanted list." *Id.* Another Pennsylvania Insurance Department news release attributes the withdrawal of companies charged with offering "gimmick" policies to shopper's guide disclosure. Pennsylvania Insurance Department News Release, Aug. 18, 1972, *reprinted in Life Insurance Hearings*, pt. 2, at 1749. *See also Shopper's Guide Sparks Are Flying*, PROBE, Oct. 9, 1972, at 1 (discussing an increase in guaranteed cash values made by Travelers Insurance Company which had the effect of taking Travelers off a list of high-cost companies).

A suggested set of standards applicable to listings or rankings of cost indexes for substantial numbers of policies is set forth in AMERICAN LIFE INSURANCE ASS'N, THE "MISUNDERSTANDING" ISSUE: COST DISCLOSURE IN THE SALES ENVIRONMENT 10-12 (1974). The same research project report sets forth standards generally applicable to cost indexes and a separate set of standards for indexes and disclosure statements used in sales situations. *See id.* at 3-10.

2. Uniformity and Disclosure

The first difference between the two methods of disclosure concerns the uniformity of standards. The NAIC proposal is only a proposal; the states are free to adopt, tailor or reject it as they see fit.[131] In contrast, the Hart bill, by inserting the Federal Trade Commission (FTC) into the life insurance cost disclosure picture, seeks "to establish national standards as to the basic cost and benefit and other relevant information . . . which shall be made available to consumers."[132] Section 7 of the bill gives the FTC rulemaking and enforcement authority, and section 4 calls upon the FTC to promulgate within 180 days of the bill's enactment detailed regulations governing disclosure to applicants.[133] Section 4 further requires the agency to publish at least once yearly a guide "comparing and ranking" companies issuing participating policies "according to the annual refunds actually paid by such insurance companies and the annual refunds illustrated originally . . . ,"[134] but there is no requirement that the FTC compare and rank policies on the basis of cost. To encourage states to upgrade their disclosure practices, the Hart bill includes a provision exempting companies which comply with disclosure regulations judged by the FTC to be equivalent to those imposed by the bill, and rules and regulations promulgated thereunder.[135]

a. *Pre-Sale Disclosure*. The second major distinction between the Hart bill and the NAIC proposal exists in disclosure philosophy and technique. A favorable aspect of the Model Regulation is its orientation toward consumer education — requiring companies to furnish both cost data and readable background information which describes what life insurance is and does. The Hart bill is concerned more with cost disclosure, apparently proceeding on the assumption that consumer education will be a by-product thereof. Though the bill does give the FTC virtual carte blanche authority to require written disclosure of "all information, data, terms and conditions which are likely to help [an] applicant make an informed and rational choice with respect to life insurance,"[136] the only background data the bill requires to be

131. The Task Force spoke forcefully to the need for uniformity among the states in REPORT OF THE NAIC TASK FORCE, June 10, 1975, at 4.

132. 121 CONG. REC. S 11,977 (daily ed. July 8, 1975) (statement of Senator Hart).

133. S. 2065, 94th Cong., 1st Sess. § 4(a) (1975).

134. *Id.* § 4(b).

135. *Id.* § 11.

136. *Id.* § 4(a).

furnished to applicants is an explanation of the differences between term and whole life insurance.[137]

Subject to FTC supplementation, the Hart bill requires that applicants be given an elaborate cost disclosure printout. The cost disclosure format generally follows the disclosure approach developed by Professor Joseph M. Belth of the University of Indiana's Graduate School of Business. Professor Belth has long been a champion of life insurance cost disclosure,[138] and it was he who first kindled Senator Hart's interest in the field in 1968.[139] Professor Belth disdains the Model Regulation, arguing that "the approach does not constitute adequate disclosure" and that the NAIC "knowingly or unknowingly . . . is assisting the life insurance industry in the perpetration of [a] cruel hoax on the life insurance buying public."[140]

The cost disclosure system used in S. 2065 is far more technically advanced, detailed and revealing than that embodied in the Model Regulation, which furnishes only sparse technical information in the policy summary through cost indexes and some raw policy data. Two major types of disclosures must be given to applicants under the Hart bill—yearly information and summary information. For the yearly information, there must be supplied for the duration of the policy eight pieces of data for each policy year, consisting of the annual premium, the face amount of the policy, the cash value, the annual "refund" (illustrated dividend), the amount of protection (face amount minus cash value), the yearly price per $1,000 of "protection" (to be determined under actuarial assumptions required by the FTC), the yearly rate of return on the "savings element" (essentially a percentage return on cash value based upon an assumed price of protection), and the cumulative annual rate of return on the savings ele-

137. *Id.* § 4(a)(5).

138. The leading experts on the technical aspects of price disclosure in the sale of life insurance are Professor Belth and Mr. Ernest J. Moorhead.

139. *See* note 82 *supra*.

140. Text of Oral Statement of Joseph M. Belth at Hearings on S. 2218 Before the Senate Subcomm. on Housing and Insurance, Dec. 3, 1975, at 16. Experts who are associated with the Model Regulation are more complimentary in the appraisal of Professor Belth's approach. *See* Task Force Remarks, *supra* note 102, at 11 (referring to Professor Belth's approach as an "excellent method [that] would be a valuable tool for an actuary making a detailed study of policies"); Testimony of E. J. Moorhead at Hearings on S. 2218 Before the Senate Subcomm. on Housing and Insurance, Dec. 3-4, 1975, at 3 (calling Professor Belth's plan an "entirely acceptable" means of disclosure, but questioning the need for it in the present market).

ment.[141] This is a voluminous amount of data. Assuming the policy has a 40-year duration, 320 numbers in chart fashion must be set forth. Additionally, the bill requires disclosure in summary form of the present expected values of the policy's premiums, "protection element," "savings element," illustrated dividends, "company retention" (the excess of premiums over the sum of illustrated dividends plus the protection and savings elements), and the payment for each rider, endorsement or other benefit. Summary disclosure is also required of annual percentage rates applicable to premium payments and loans.[142] Finally, the bill requires disclosure to applicants of the name of each state in which the insurer is subject to expense limitations, the company's thirteen month lapse rate for the latest calendar year, and the explanation of term and whole life insurance that was mentioned earlier.

The Model Regulation develops its simple disclosure method by adding an interest assumption to raw policy data. The Hart bill goes further, requiring the use of interest, mortality, and lapse assumptions in the calculation of rates of return and present

141. S. 2065, 94th Cong., 1st Sess. § 4(2) (1975). Most of the terms used in section 4(2) are defined in section 3.

142. *See id.* § 4(1). By way of example, Senator Hart presented the following summary information when he introduced S. 2065:

SUMMARY INFORMATION

($25,000 Participating straight life policy issued by Northwestern Mutual in 1973 to males aged 35)

Present expected values:	
Premiums	$6,899
COMPONENTS OF THE PREMIUMS	
Protection element	$1,149
Savings element	2,326
Illustrated dividends	2,575
Company retention	849
Total	$6,899
SUPPLEMENTARY PREMIUMS	
Waiver of premium	$110
Accidental death benefit	229
	percent
Ratio of benefits to premiums:	80.4
ANNUAL PERCENTAGE RATES	
	percent
Semi-annual premiums	8.2
Quarterly premiums	8.0
Monthly premiums	7.0
Loan clause	6.0

121 CONG. REC. S 11,980 (daily ed. July 8, 1975) (footnotes omitted).

expected values of policy elements.[143] These additional assumptions give the bill's presentation a more arbitrary or hypothetical flavor than is the case with the NAIC proposal.[144] At the same time the assumptions make possible disclosures that arguably present a more vivid portrayal of the way life insurance works and what it costs than is depicted by the Model Regulation's disclosures.

If not more vivid, the Hart bill's format is certainly more complex.[145] There are some important advantages to the complexity. For one thing, the year-by-year tabular format spotlights the "front-end load" aspect of many life insurance policies.[146] This should help warn consumers of the risk of loss due to early lapsation, but this method of warning may not be superior to the caution set forth in narrative form in the Model Regulation buyer's guide. A more obvious advantage of the bill's approach is its methodology which permits the presentation of cost information in two easily understandable modes: in percentage form (ratio of benefits to premiums and cumulative annual rate of return on the savings element) and in total dollars for the policy (company retention). Many consumers would probably find these figures easier to work with than the index numbers offered by the Model Regulation. The rate of return figure could be particularly beneficial. Senator Hart's study of life insurance policies dis-

143. The present value calculations set forth in the sample summary information presented in note 142 *supra* are based on an assumed rate of interest of five percent, the 1957-60 ultimate basic mortality table for males, and Moorhead's modified R lapse table. *Id.* Another area where assumptions are used in the bill is in calculating the yearly rates of return on the savings element. A footnote accompanying an illustration of the bill's presentation of yearly information states that the rates illustrated are based upon the assumption of "yearly prices per $1000 of protection equal to 105 percent of the one-year term insurance rates of Revenue Ruling 55-747." *Id.* It is not clear whether the footnote would accompany the disclosure.

144. *Cf.* Written Statement of Jack Kvernland, *supra* note 104 (attachment II). One of the points made against the bill's use of lapse tables in fixing costs is that the tables have high early year rates and low later year rates, whereas informed purchasers (such as those who benefit from disclosure regulations) should have opposite patterns. *Id.* at 2.

145. A largely complete sample policy information format is set forth at 121 CONG. REC. S 11,980 (daily ed. July 8, 1975). The basic format is presented with comments by its originator in Belth, *Information Disclosure to the Life Insurance Consumer*, 24 DRAKE L. REV. 727 (1975).

146. So called because in many policies, particularly whole life policies, the major share of the costs of the policy to the policyholder (the "load") is deducted from premiums during the early years of ownership (the "front-end"). The term originated in the contractual plan segment of the mutual fund industry.

closed that while most of the policies studied had rates of return on their "savings elements" varying from .5 percent to 3.5 percent, a few policies had rates of 5.2 percent.[147] This could be very valuable information to the prospective purchaser.

It is questionable whether the same can be said for the full-blown yearly summary that the bill envisions being given to prospects. A chart with 320 numbers on it will create more confusion than it clears up for many buyers. The rationale for this type presentation was explained by Senator Hart: "This year by year information for the life of the policy is needed to ferret out unusual or misleading dividend and cash value patterns or other types of value manipulation."[148] This justification puts undeserved reliance on the average policyholder's analytical skills. If, as Senator Hart has also observed, "few more than a handful of Americans understand life insurance or what this protection costs them,"[149] then it seems extreme to expect the uninitiated to ponder a slip of paper and suddenly reach the point of sophistication that allows them to "ferret out" an aberrational policy structure. If the purpose of the comprehensive year-by-year breakdown is to aid in detecting manipulation, that purpose might be better accomplished by requiring that the data be compiled for hypothetical ages and coverages and filed with the NAIC or the various state regulators, as was suggested earlier,[150] or the FTC. Actuaries employed by those agencies could be expected to spot any manipulation quickly.

By opting for the Belth disclosure system, the Hart bill puts its stock in what is arguably the most complete, and certainly the most complex, of the leading cost disclosure structures. It is the "Cadillac" of its type, but common sense teaches that there must

---

147. 121 CONG. REC. S 11,976 (daily ed. July 8, 1975). It is difficult to quarrel with Professor Belth when he says:

> Suppose . . . that the rate of return on the savings element . . . is currently running 2 percent. . . . [S]uch a company ought to be placed in the position of having to justify the situation to the policyholder, rather than being shielded by a lack of disclosure.

Text of Oral Statement of Joseph M. Belth, *supra* note 140, at 15.

148. 121 CONG. REC. S 11,977 (daily ed. July 8, 1975) (remarks of Senator Hart).

149. *Id.* at S 11,975. In his opening statement at the beginning of the life insurance hearings, Senator Hart made essentially the same point. "More than 300,000 times a day, all year long, American consumers pay a bill without having more than a somewhat vague idea of what they are buying." *Life Insurance Hearings*, pt. 1, at 1.

150. *See* note 124 *supra* and accompanying text. Another approach, suggested by E. J. Moorhead, is presented in note 116 *supra*.

usually be a trade-off between comprehensiveness and understandability. Also, it stands to reason that scope of disclosure is related to cost, and it is clear that any expenses will ultimately be paid by the policyholder.[151] When weighing the merits of the bill's disclosure system against that of the Model Regulation, it should be kept in mind that the NAIC Task Force concluded after thorough study that the Model Regulation's interest-adjusted method was superior.[152] The Task Force observed that: "The consumer will be best served by a cost comparison method that, within the limits of acceptable validity, introduces the least number of unfamiliar concepts."[153] Two key "unfamiliar

151. In a statement presented to a Senate subcommittee, the Prudential Insurance Company estimated "developmental costs" for the Senate bill's disclosure system at $2 million compared with $200,000 for the Model Regulation. The estimated annual cost of disclosure was $8 million for the Senate bill and $5 million for the Model Regulation, assuming disclosure was made prior to taking an application. The figures were $550,000 and $450,000, respectively, assuming disclosure is made at the time the policy is delivered. Written Statement of Jack T. Kvernland, *supra* note 104, item 14 at 2. Professor Belth objected to the projection of $2 million in developmental costs as "excessively large," but felt the $550,000 figure for disclosure at delivery was reasonable. Text of Oral Statement of Joseph M. Belth, *supra* note 140, at 15. Professor Belth also noted that Prudential issued approximately 1.3 million ordinary policies in 1974. *Id.* For the sake of comparison, Northwestern Mutual Insurance Company estimated the total initial costs attendant to compliance with the Model Regulation as $15,000 for computer programming and 55 cents per prospect for continuing delivery costs. Statement by H. Daniel Gardner to the NAIC Task Force, Nov. 17, 1975, at 4.

152. Among the studies considered by the Task Force was E.J. MOORHEAD, "SNAPSHOT" AND "AVERAGE" APPROACHES TO POLICY COST COMPARISON (1975). A comparison of the qualities of "snapshot" cost approaches such as the interest-adjusted cost method with "average" methods such as the "company retention" method advocated by Belth led to the conclusion that the average method "packs into the cost index the larger amount of information about the characteristics of the policy contract." The average method also was judged superior in permitting comparisons of and allowing an understanding of the comparative merits of dissimilar policies. Also, the average method was considered better at portraying a policy as a package of protection and savings elements. However, the snapshot method was rated better in ease of explanation, "calculability," "quality of assumptions" (applying the rule that the fewer the better), and adaptability (enabling a "user to consider price in relation to his own intentions with respect to the policy").

153. REPORT OF THE NAIC TASK FORCE (June 10, 1975). This same conclusion is repeated in another study report considered by the Task Force. See INSTITUTE OF LIFE INSURANCE & LIFE INSURANCE MARKETING & RESEARCH ASS'N, LIFE INSURANCE CONSUMERS: A NATIONAL SURVEY OF COST COMPARISON ATTITUDES AND EXPERIENCE 8 (1975). The latter report observed that:

> The survey results raise the real possibility that when a given cost comparison method is not easily understood, rather than help consumers locate the best buy, it may cause them not to buy. This suggests the choice of a "snapshot" [approach] - such as the interest-adjusted method - rather than an "average" approach to cost comparison, if a standard cost index is to be adopted.

Id.

concepts" introduced by the Belth system are mortality and lapse assumptions. The addition of these assumptions gives the Belth system its uniqueness and much of its complexity. Accordingly, it is important that the NAIC concluded that ignoring mortality does not have a very great effect on cost rankings and that "[v]astly different" lapse rate patterns have similarly little effect.[154] Since the chief value of cost disclosure lies in the cost comparisons it facilitates, the apparent failure of the Belth presale disclosure system to afford significantly greater accuracy for its increased complexity is a very serious shortcoming.

b. *Post-Sale Disclosure.* A seemingly more useful disclosure requirement in section 5(2) of the Hart bill, and one that has no counterpart in the Model Regulation, mandates post-sale disclosures be made on an annual basis. That section requires that premium notices or dividend declarations set forth the following: (1) premium payable; (2) current annual refund (dividend);[155] (3) dividend illustrated at the time the policy was sold; (4) accumulated dividends; (5) annual percentage rate currently applicable to accumulated dividends; (6) current face amount and cash value of any insurance purchased by dividends; (7) annual rate of return and (8) current principal, accrued interest, and annual percentage rate applicable to outstanding policy loans. Presentation of the dividend data would discourage companies from showing large illustrated dividends at the time of sale to make the cost look low and then paying smaller dividends than projected. This policing effect was what Professor Belth wanted to achieve when he developed the concept of post-sale disclosure embodied in the bill.[156] The yearly update should also help policyholders to understand better the product they bought, which might provide some protection against uneconomic replacement or lapsation.[157]

154. REPORT OF THE NAIC TASK FORCE, (June 10, 1975) at 3.

155. Refunds are defined in S. 2065, 94th Cong., 1st Sess. § 3(29) (1975).

156. *See* Belth, *supra* note 40, at 1069; *Life Insurance Hearings*, pt. 1, at 535-36. Insofar as the post-sale disclosure approach is designed to accomplish the objective of holding insurers accountable for their dividend projections, it seems to cover the same ground as the mandate in § 4(b) that the FTC publish a guide comparing actual dividends with illustrated dividends. For an analysis of existing statutes and regulations bearing on dividend computation and dissemination of dividend illustrations, see SOCIETY OF ACTUARIES, PHILOSOPHIES IN THE COMPUTATION AND DISSEMINATION OF DIVIDEND ILLUSTRATIONS 63-74 (1974).

157. A relationship between investor understanding and lapsation has been recognized by the NAIC Task Force. *See* Task Force Remarks, *supra* note 102, at 10. Additional

3. Remedies

The Hart bill construes noncompliance with any of the disclosure provisions as an "unfair and deceptive act or practice" in violation of section 5 of the Federal Trade Commission Act[158] with enforcement by the FTC and private civil actions. Minimum recovery by an aggrieved applicant or policyholder who sues successfully is $100, with a $250,000 maximum for class actions, together with costs and reasonable attorneys' fees.[159] Criminal penalties are provided for willful violations.[160] Contrasted with this rather comprehensive scheme, the Model Regulation leaves enforcement solely to the states, and it is debatable whether state insurance departments will police agents and companies as effectively as the FTC or whether state courts will be as hospitable to "private attorneys general."[161]

---

support for this hypothesis is found in the experience of mutual funds. One financial columnist said this about his experiences with frustrated mutual fund shareholders:

> I can tell you without fear of contradiction that any time a mutual fund investor is puzzled, mystified, or left in the dark, he redeems. After all, this money is important to him, and if he gets unsure about it, he wants his money back. . . . I assume that many large fund organizations have active and efficient investor relations departments. But if they are functioning properly, why do . . . so many readers ask me how to redeem their shares?

Shulsky, *A Financial Reporter's Advice to the Mutual Fund Industry*, MUTUAL FUNDS FORUM, Aug. 1972, at 6. Since policyholder lapsation and mutual fund redemption are somewhat similar phenomena, the lesson in shareholder relations which Shulsky teaches should have application to life insurance marketing. More discussion of the relationship between post-sale service and lapsation is set forth in text accompanying note 182 *infra*.

158. 15 U.S.C. § 45 (1970).

159. S. 2065, 94th Cong., 1st Sess. § 8 (1975). The provisions of section 8 are modeled after the remedial advantages given civil claimants under the Truth-in-Lending Act. *Compare id. with* 15 U.S.C.A. § 1640 (Supp. 1976).

160. S. 2065, 94th Cong., 1st Sess. § 9 (1975).

161. A key problem civil litigants must face is the feasibility of bringing suit to obtain redress for what will be, in many cases, relatively insubstantial pecuniary harm. By providing for reasonable attorneys' fees, the Hart bill corrects an imbalance in litigating power. In the absence of such a provision, many potential plaintiffs will be at a serious disadvantage, since few states have endorsed the class action device which is the primary means of assistance for consumers facing a feasibility problem. *Cf.* Eckhardt, *Consumer Class Actions*, 45 NOTRE DAME LAWYER 63 (1970); Homberger, *State Class Action and the Federal Rule*, 71 COL. L. REV. 609 (1971).

Claimants bringing class actions in the absence of legislative authority are not likely to find the federal courts much more hospitable than the state courts. Under Zahn v. International Paper Co., 414 U.S. 291 (1973), where the claims are different it will be necessary for each class claimant to have a claim for relief in excess of $10,000 if the suit is a diversity action. Further, if the suit falls within the coverage of FED. R. CIV. P. 23(b)(3), it will be necessary for the class representative to pay for dissemination of notice of the action to the class. *See* Eisen v. Carlisle & Jacqueline, 417 U.S. 156 (1974). If the

4. Sales Force Professionalism

While there are obvious and important differences between the Hart bill and the NAIC measure in terms of the data presented and remedial avenues available in the event of noncompliance, probably the greatest difference in scope between the two programs relates not to the issue of disclosure, but to an issue that is at the very heart of the industry's marketing system: the professionalism of the industry's agency force. According to testimony presented at the life insurance hearings, life insurance salespersons are often incompetent[162] and may lack the inclination or the ability to function as professional persons in the sense of putting their clients' interests ahead of their own.[163] The "professionalism" issue is central to the price competition goal of any disclosure-cost comparison proposal since, in many cases, what the prospect buys will depend directly on what the salesperson is willing to sell.[164]

action is an injunction action, the need to pay for notice may be avoided, but the attorney for the class members must look to the class for his or her fee in the event the suit is successful. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975).

In light of the serious practical difficulties facing potential private litigants, it may be expected that in the absence of federal legislation the chief enforcer of disclosure requirements will be the state insurance departments. The NAIC has taken the position that insurance department complaint procedures serve policyholders better than private lawsuits. NAIC VLI Comments, *supra* note 59, at 101. For a detailed discussion of how consumer complaints are handled by one state's insurance department, see Whitford and Kimball, *supra* note 63.

162. When asked about a charge he had made that 40 percent of life insurance agents were incompetent, Commissioner Denenberg said that 40 percent

> is probably a conservative figure.
>
> I have had many experts in the field . . . tell me that it is way low. If you really talk about agents who know what they are doing, it would be much higher
>
> . . . .

Life Insurance Hearings, pt. 3, at 1558.

163. *See, e.g.*, *Life Insurance Hearings*, pt. 2, at 1099 (testimony of Professor Spencer Kimball) ("On how many occasions does an agent now advise his potential client to buy his insurance elsewhere?"). This same basic theme has been echoed in other places and contexts. *E.g.*, H. DENENBERG & J. FERRARI, *supra* note 17, at 50 ("Every life insurance salesman must attempt to sell his product even though he is aware that lower-priced — and sometimes superior — products are available."); Letter from Arthur Levitt, Jr., President, CBWL—Hayden Stone, in FORBES, July 15, 1973, at 23 ("The method of [securities] brokers' compensation can create certain conflicts and, by its very nature defies the notion of professionalism so important to the salesman's view of himself and his customer."); Letter from William K. Paynter, Executive Director of the Institute of Life Insurance, to John P. Freeman, July 10, 1973, at 3 ("Like all salesmen [life insurance salesmen] sell what they have to sell.").

164. The significance of this reliance factor is reflected by a recent study of life insurance purchasers which showed that nearly 80 percent of recent purchasers believed

It was observed at the hearings that sales personnel may play a major role in putting downward pressure on prices by lobbying with their companies for low cost policies and by migrating from high cost to low cost companies if requested price cuts are not forthcoming.[165] On the other hand, there was also testimony that the impact of any ripple effect which the loss of agent loyalty may have on price competition is open to question since a large percentage of life insurance sales personnel have their earnings tied to "nonvested commissions" — commissions that agents receive after the first year of a policy and which may be forfeited if an agent changes companies.[166] The wide usage of nonvested commissions among leading life insurance companies was subsequently confirmed by empirical data generated by the Antitrust and Monopoly Subcommittee's staff.[167]

---

that a single agent or company could be counted on to supply sufficient cost information. Among the reasons given for this belief were confidence in an agent or company and the perception that agents and/or companies are fungible. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE CONSUMERS: AN EXPLORATORY STUDY OF ATTITUDES AND EXPECTATIONS REGARDING COST COMPARISON 12 (1974).

165. *E.g., Life Insurance Hearings*, pt. 1, at 33 (testimony of Ralph Nader); *id.*, pt. 2, at 1103 (testimony of Professor Spencer Kimball); *id.*, pt. 3, at 1525 (written statement of Herbert Denenberg). In the course of pointing out that there already is a measure of price competition in the life insurance market, Mr. Ernest J. Moorhead stated at the life insurance hearings that

> there is at present and has been for a large number of years, a considerable pressure on the actuaries in the home offices to improve dividend scales, that pressure being exerted by the agents.
>
> The agents are not interested in being embarrassed by finding that their product will not stand up in competition. They also are honest individuals who want to be able to present a product that they can be proud of. So they get after the company to accomplish the best earnings on its investment that can be arranged and to keep its expenses down; and they get after the actuary to develop the most attractive dividend scale in order that it may be competitive.

Id., pt. 1, at 714. For further discussion of competitive pressure generated by agents, see Sesser, *Insurers Under Fire*, Wall Street J., Sept. 5, 1967, at 1, col. 6.

166. *See Life Insurance Hearings*, pt. 1, at 533-34, 553-55 (testimony of Joseph M. Belth); *id.*, pt. 2, at 1103 (testimony of Professor Spencer Kimball). It has been estimated that "perhaps 75 percent of life insurance agents have exclusive contracts or career contracts with a primary company." *Id.*, pt. 3, at 1555 (statement of Dean Sharp). For a detailed discussion of non-vested commissions and a call for legislation to protect agents from loss of non-vested renewal commissions because of termination without just cause, see Note, *Insurance Agent's Right to Renewal Commissions After Termination: Time for a Change in Policy*, 9 U.S.F.L. REV. 683 (1975).

167. As part of the subcommittee's study of life insurance marketing, questionnaires were sent out to numerous companies requesting, among other things, samples of agents' contracts used by the companies. Copies of provisions relating to termination rights and exclusive representation duties in contracts filed with the subcommittee are set forth in *Life Insurance Hearings*, pt. 4, at 2845-57. A breakdown of commissions as a percentage

Unlike the Model Regulation, the Hart bill focuses directly on the issue of sales force professionalism. Section 6 establishes as a goal the promotion of the independence and security of sales personnel. In furtherance of that goal, the section outlaws a "primary company" (a company with whom an agent places a majority on his or her business) from engaging in certain "prohibited acts" with respect to those of its agents who have been employed for three or more years. In brief, the section labels as prohibited acts the use of: exclusive dealing or right of first refusal clauses in agency contracts; harassment, intimidation or pressure designed to keep an agent from selling another company's policies; and nonvested commissions. The section also requires that a company terminating an agent must file a written explanation with the pertinent state insurance commissioner reciting the relevant facts surrounding the termination.

Section 6 provides both a means of furthering the basic price competition thrust of the bill and a way of alleviating some of the problems of professionalism and product suitability which may arise when salespersons have only one company's products to sell. These would be wholesome changes. At the same time, the section poses some problems. It costs money to recruit, train and supervise a quality sales force, and presumably, the greater the time and care devoted to these tasks, the greater the expense. The bill gives no assurance that companies which assiduously cultivate quality sales forces will not have their sales forces depleted by raiding from other companies with the costs generated from any raiding ultimately passed on to the consumer. Additionally, companies that lose substantial numbers of highly trained personnel may be less anxious in the future to spend large amounts on agent recruitment and training. Who can be certain that the overall level of professionalism may not decline in the face of any cutbacks in these areas? Moreover, there is no guarantee that sales personnel will use their new found independence to sell low cost policies. Some agents would likely be more interested in migrating in the direction of the highest sales commissions than toward the low cost sellers. In fact, it is not difficult to imagine upward pressure on sales commissions as sales personnel become

of premiums during each of the first 20 years for certain term and whole life policies issued by a number of companies is presented in *id.* at 2860-85.

"free agents."[168] It is worth repeating that any increased selling costs must be paid by the consumer.

In short, section 6 is a mixed bag. According to Senator Hart, the section is designed to "allow agents to be sufficiently independent to do a truly professional job for the consumers."[169] The provision seeks to cultivate professionalism by driving a wedge between companies and sales personnel but fails to recognize that there may be value in proceeding from the opposite direction by attempting to strengthen the bond between sales personnel and customers. The bill fails to stipulate basic duties of candor and fairness owed by sales personnel. Requiring the discharge of such duties could materially assist the cost disclosure/price competition theme of the bill. In weighing the value of the bill's "wedge" approach, it must be recognized that while independence may be a necessary predicate, it alone is not sufficient to guarantee professionalism in the context of individual life insurance marketing. It is doubtful sales personnel in the industry can ever do a truly professional job when compensation is by commission.[170]

5. Summary

If enacted into law, S. 2065 would certainly revolutionize the way individual life insurance is marketed. Whether the means used by the bill to bring about that revolution would be ultimately in the best interest of the consumer is a question that deserves full airing before any final action is taken on the pro-

168. There is substantial support for the view that life insurance and equity products are marketed by sales forces primarily interested in maximizing commission income. *E.g.*, INSTITUTIONAL INVESTOR REPORT, *supra* note 12, at 537 (reporting "a pervasive attitude" among insurance companies' "more productive agents" that life insurance will normally be sold instead of annuities, absent special tax considerations, because of disparities in compensation); VLI STAFF REPORT 135-36 (suggesting that insurance salesmen will not sell variable life insurance for less compensation than could be earned selling fixed-benefit life insurance); Distribution Hearing Transcript 177-78, 183 (remarks of Robert L. Augenblick); *id.* at 431 (remarks of Daniel C. Samuel); *id.* at 1124-25 (remarks of Manuel Glassman); Statement of Putnam Management Company, Inc., Feb. 2, 1973, at 4, SEC File No. 4-164; Statement of Crosby Corp., Jan. 29, 1973, at 4, SEC File No. 4-164; Thaler, *Life Insurance Sales of Investment Company Shares: A Survey*, MUTUAL FUNDS FORUM, Apr. 1973, at 6, 7 (reporting as a major reason for an unwillingness of life insurance agents to sell equity products "the unfavorable perception by the agent of the low percentage commissions on an equity sale vs. a higher percentage commission on the insurance sale"); *The Funds*, FORBES, June 15, 1972, at 85 (quoting Charles Collova).

169. 121 CONG. REC. S 11,977 (daily ed. July 8, 1975).

170. *See* Letter from Arthur Levitt, Jr., *supra* note 163.

posal.[171] Some speculation about the possible impact of the bill and its NAIC counterpart on consumers, sales personnel and insurance company managements is set forth below.

D. *Reform and the Public*

There are three basic types of knowledge that a prospect ideally should have when debating a life insurance purchase decision: (1) knowledge of available types of policies and options; (2) knowledge of which coverage is most suitable for the prospect's personal situation; and (3) knowledge of how to obtain suitable coverage from a reputable company at the lowest possible cost. The Model Regulation serves each of these three needs through a comprehensive disclosure system designed to educate prospects on the subject of life insurance and sensitize them to product cost. In contrast, the Hart bill appears to contemplate consumer education as a side effect of more complete cost disclosure.[172] Comparing the two approaches, it seems more sensible to view price sophistication as preceded by a basic understanding of life insurance than vice versa. In any event, even though implementation of either approach should enlarge that segment of the individual life insurance market which is cost conscious, it is probable that

171. In light of the far-reaching reforms which S. 2065 seeks to effect, any study of the bill should explore the potential economic impact of the bill's adoption. It is worth noting that federal agencies are already required to conduct cost studies of proposed "major" legislation, regulations, or rules. *See* Exec. Order No. 11,821, 3A C.F.R. 203 (1974). Accordingly, the FTC, which has major rulemaking responsibilities under S. 2065, would be required to conduct an "inflationary impact analysis" prior to promulgation of any rules. But it is hoped that a rigorous economic analysis of the impact of the legislation would not wait until after adoption. Guidelines established by the Office of Management and Budget to cover such appraisals indicate that a proposal's cost evaluation should include the study of a wide range of variables. *See* OMB Circular No. A-107 (Jan. 28, 1975). The areas of inquiry raised in the OMB guidelines should provide some starting points for a responsible analysis of the desirability of restructuring the distribution system of the life insurance industry.

172. The Hart bill generally adopts Professor Belth's disclosure approach and it seems to embody his view that cost disclosure can lead to increased buyer sophistication. At the hearings Professor Belth observed that cost disclosure could perform a "tremendous educational function" though "it would take many, many years." *Life Insurance Hearings*, pt. 1, at 540. It is debatable whether cost disclosure standing alone is the best means of educating consumers. *See* note 109 *supra* and accompanying text. For background information on the current state of buyer sophistication in the individual life insurance marketplace, see INSTITUTE OF LIFE INSURANCE & LIFE INSURANCE MARKETING & RESEARCH ASS'N, LIFE INSURANCE CONSUMERS: A NATIONAL SURVEY OF COST COMPARISON ATTITUDES AND EXPERIENCE (1975); LIFE INSURANCE AGENCY MANAGEMENT ASS'N, LIFE INSURANCE CONSUMERS (1973). *See also* note 40 *supra*.

segment will remain a minority. A recent study showed that only one-third of the nation's adults presently are proficient in coping with the basic requirements related to consumer economics.[173] Given this present low level of adult functional competence, it seems unlikely that consumer ignorance will ever be eradicated from the individual life insurance marketplace by any disclosure approach, no matter how well-intentioned or thorough.[174]

Another reality is the failure of both the Hart bill and NAIC proposal to require agents to furnish *any* comparative cost figures to prospects. It is unlikely that salespersons working with prospects in one-on-one sales settings will be anxious to make cost comparisons unless cost is a favorable selling point, in which case

---

173. *See* ADULT FUNCTIONAL COMPETENCY: A SUMMARY 6 (N. Northcutt, ed. Mar. 1975), copy on file with the *South Carolina Law Review*.

174. This skepticism has been expressed elsewhere. *See Life Insurance Hearings*, pt. 2, at 1103 (testimony of Professor Spencer Kimball); White, *Cost Disclosure and Comparisons—the Direction of Emerging Requirements*, BEST'S REV., Aug. 1975, at 26, 28 (Life ed.).

On the other hand, the point has been made in connection with truth-in-lending legislation that:

> Not all consumers need be aware of the APR or shop for credit to bring about effective price competition. A significant marginal group of consumers who are aware and do shop is sufficient to "police" the market. As Senator Douglas pointed out in the House hearings on H.R. 11601:
>
> > . . . it is the undecided minority that influences the sellers. So you need only have, in my judgment, about 10 percent cost conscious and they will get the firms competing for that 10 percent.

REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 176 (proof copy 1972). *But cf.* INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE CONSUMERS: AN EXPLORATORY STUDY OF ATTITUDES AND EXPECTATIONS REGARDING COST COMPARISONS 4-5 (1974); Whitford, *The Functions of Disclosure Regulation in Consumer Transactions*, 1973 WIS. L. REV. 400, 469.

It is true that the Model Regulation is designed for use by people with little familiarity with life insurance. Thus, the buyer's guide is being written to achieve readability at the eighth grade level. But it is also true that there is a certain irreducible amount of technical detail in the subject area, and much of the detail revolves around mathematical concepts. On this point it deserves mention that "the mathematical skills of 17-year-olds is now so low that fewer than one in 100 is able to balance a checkbook." Pressley, *Inflation Hits the Campuses*, Wall Street J., Jan. 21, 1976, at 16, cols. 4-6.

It is worth noting also that in 1974 nearly 50 percent of all individual life insurance policies, and approximately 30 percent of the amount of policies issued, were issued to insureds with incomes of under $10,000. *See* INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1975, at 14. (The compilation excludes persons aged 0-14 and persons without incomes). The large number of policies issued to people in this income group is significant in appraising the value of cost disclosure because "most consumer studies have found that people with incomes of $10,000 to $12,000 or less have difficulty . . . understanding consumer information." *Life Insurance Hearings*, pt. 2, at 1379 (statement of Dean Sharp).

there should be only minimal benefit from the effort. On the other hand, there are signs that low cost companies themselves are stepping into the disclosure picture by using promotional themes intended to exploit their marketing position.[175] Continuation of this trend should serve to broaden the cost conscious segment of the market and thus put downward pressure on prices.

Another, less profound, effect of expanded cost sensitivity may be to increase the extent to which life insurance purchasers experience post-purchase anxiety, sometimes called "cognitive dissonance," a name given by psychologists to a state of anxiety experienced by consumers after making an important purchase decision.[176] The anxiety arises when the consumer is forced to forego enjoyment of attractive features of products not purchased and to live with unattractive features of the product purchased. When the product purchased matches the purchaser's needs, pleases friends, causes little financial hardship and has no known attractive alternatives, little dissonance will be experienced. Dissonance should increase to the extent these factors do not apply.[177] Post-purchase anxiety may also be generated when "the purchaser learns that he could have purchased the product for less elsewhere."[178] Once aroused, this dissonance may be reduced

175. A recent ad by The Bankers Life Company carried the headline, "Don't give your money away. Compare Costs when buying life insurance." SPORTS ILLUSTRATED, Aug. 11, 1975, at 65. Phoenix Mutual recently ran an ad comparing interest-adjusted cost indexes for one of its policies with those written by fourteen other named companies. *See* NEW YORK MAGAZINE, July 7, 1975, at 11.

176. The theory of cognitive dissonance was pioneered by Leon Festinger. *See generally* L. FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1958); P. KOTLER, *supra* note 2, at 135-36. Various aspects of the theory are explored in Ehrlich, Guttman, Schonbach & Mills, *Postdecision Exposure to Relevant Information*, 55 J. ABNORMAL SOCIAL PSYCHOLOGY 98 (1957); Engel, *Further Pursuit of the Dissonant Consumer: A Comment*, J. MARKETING, Apr. 1965, at 33; Holloway, *An Experiment in Consumer Dissonance*, J. MARKETING, Jan. 1967, at 39; Hunt, *Post-Transaction Communications and Dissonance Reduction*, J. MARKETING, July 1970, at 46; Mittlestaedt, *A Dissonance Approach to Repeat Purchasing Behavior*, 6 J. MARKETING RESEARCH 444 (1969); Straits, *The Pursuit of the Dissonant Consumer*, J. MARKETING, July 1964, at 62.

177. *See* Bell, *The Automobile Buyer After the Purchase*, J. MARKETING, July 1967, at 12, 13.

178. P. KOTLER, *supra* note 2, at 135. Some support for this view comes in the form of testimony presented by one mutual fund manager at the mutual fund distribution hearings. The manager told of one problem he foresaw if the same fund were sold at different prices by different dealers:

> And what of the recriminations and ill will that would be created for a mutual fund if one shareholder bought his shares in the fund at an 8 percent commission and then learned that another shareholder had bought his shares on the same

or eliminated by receipt of favorable information about the product purchased. Indeed, it is not unusual for consumers to actively seek out approval of their purchases particularly where a contrary opinion has been stated by an authoritative source.[179] The consonant information sought by the consumer may take the form of peer approval of the purchase, a good rating given the product by an impartial source such as *Consumer Reports*, or even advertisements or other communications through channels controlled by the seller. If the dissonance is severe and the purchaser is unable to reduce anxiety, he or she may attempt to return the product to the seller.[180]

Cognitive dissonance theory maintains that: "[u]nless the seller dispels the dissonance by some positive efforts, he may lose the customer unnecessarily."[181] This seems to fit with one expert's analysis of a means of preventing unnecessary lapsation in the individual life insurance market:

> Various research studies of the time of lapsation find that the most critical time for lapsation is when the second premium is due, . . . and we find that at that time . . . the agent needs to call on the client . . . and resell the policy to him and tell him why he bought it in the first place.[182]

To the extent that cognitive dissonance theory is applicable to the individual life insurance market, it predicts that the greater availability of cost data will lead to substantial post-purchase anxiety in some persons purchasing policies from high cost companies. Having committed themselves to a high cost company, some purchasers are likely to learn of large cost disparities for the first time when they seek approval of their purchase from others. Because of the large front-end load common to whole life policies,

---

> day from another dealer at only four percent commission? Obviously, the investor who paid the higher commission would forever feel that he was cheated by the mutual fund when he purchased his shares, although the fund was only doing what it was legally allowed to do.

Distribution Hearings Transcript at 361-62 (testimony of Ralph C. Coleman, Jr.).

179. *See* Adams, *Reduction of Cognitive Dissonance by Seeking Consonant Information*, 62 J. ABNORMAL SOCIAL PSYCHOLOGY 74 (1960); Ehrlich, Guttman, Schonbach & Mills, *supra* note 176.

180. Holloway, *supra* note 176, at 40. The dissonant consumer may also attempt to alleviate his anxiety by changing his assessment of relevant factors or ignoring data that conflicts with his view. *Id. Cf.* Adams, *supra* note 179.

181. P. KOTLER, *supra* note 2, at 135.

182. *Life Insurance Hearings*, pt. 4, at 2255 (testimony of Alfred G. Whitney).

replacement of the high cost policy with one issued by a low cost company may not be economically advantageous for the disenchanted policyholder.[183] In such a case the newly educated purchaser has the unattractive options of learning to live with his or her post-purchase anxiety, allowing the policy to lapse, or making what may be an uneconomic replacement.

A means of assisting those who become cost conscious shortly after the sale is to provide a "free-look" period during which policies can be returned. Besides serving as a check on overselling, a free-look right could materially further the goal of increasing price competition since many persons who exercise the right could be expected to switch to low cost offerings. The Hart bill lacks a free-look provision, but the Model Regulation does provide a modicum of relief in the form of a 10-day free-look right. The free-look right does not apply if cost information is supplied to the buyer prior to taking an application.[184] The Model Regulation's tame approach is in sharp contrast to the mandatory 45-day free-look period Congress adopted in the case of securities sold pursuant to a front-end loading arrangement.[185] Moreover,

---

183. *See* J. BELTH, LIFE INSURANCE: A CONSUMERS' HANDBOOK 160-61 (1973); Kimball and Rapaport, *supra* note 47, at 1036 & n.41. There are circumstances under which replacement is in the customer's best interest:

> Assuming that replacement is not for the purpose of changing to a more appropriate plan, that both policies are of the same nature, and that both are held to maturity, replacement is economically justifiable when the present value of the sum of all future premiums under the first policy is greater than the present value of the sum of all future premiums under the second policy less the present cash value of the first policy.

Kimball & Jackson, *supra* note 63, at 194. *See also Replacement is Not Necessarily Twisting*, 3 INS. FORUM, Feb. 1976, at 3.

184. MODEL REGULATION § 5(A). A number of life insurance companies already have voluntarily granted life insurance purchasers a 10-day free-look privilege. Additionally, at least one state, Wisconsin, grants a 10-day free-look period to insurance purchasers, though the privilege is limited to health insurance. WIS. STAT. § 204.31(2)(a)8 (1971). For argument in favor of a mandatory 30-day free-look period in cases where cost indexes are furnished at the time the policy is delivered, see Goodwin, *We Need Straight Talk on Life Costs*, BEST'S REV., Apr. 1975, at 14, 73 (Life ed.) (10-day period was judged too short to permit comparison shopping).

185. Investment Company Act of 1940 § 27(f), 15 U.S.C. § 80a-27(f) (Supp. 1971). The 45-day period starts to run from the time notice of the withdrawal is mailed to the investor. Further discussion of the limitation of front-end load commissions in connection with mutual fund marketing is presented in note 372 *infra* and accompanying text. For a comparison of the regulation of sales loads in the life insurance and mutual fund industries, *see generally* VLI STAFF REPORT 134-55.

the NAIC has itself provided in its Model Variable Life Insurance Regulation for a mandatory free-look period of at least 45 days from the date an application is executed.[186] The NAIC's variable life insurance regulation also requires that notice of the free-look right be prominently displayed on the cover of the policy. The Model Regulation does not require notice of the free-look right in the buyer's guide or the policy. States which adopt the Model Regulation should be sure to correct the notice oversight — preferably by requiring disclosure of the free-look right in both the policy and the buyer's guide. Mandatory notice by mail is another alternative. The states should also consider extending the length of the free-look period to provide more substantial relief to consumers who experience cognitive dissonance.

E. *Reform and Sales Personnel*

If cost disclosure stimulates price competition, high cost policies should become harder to sell. As was pointed out in the discussion of the professionalism aspect of the Hart bill, customer resistance will not be the only source of competitive pressure exerted on high cost companies; sales personnel of high cost companies should be a prime source of pressure for cost reductions as customer sophistication grows and resistance to high cost offerings intensifies.[187] If cost reductions are not forthcoming, it is foreseeable that high cost companies will lose sales personnel to companies whose policies are more competitively priced. But the magnitude of any such migration would be limited substantially

186. MODEL VLI REGULATION, art. IV, § 3a(5). The free-look period lasts 45 days from the date the application is executed or 10 days from the date the policy is delivered, whichever is longer. The variable life insurance proposal also features a provision allowing a policyholder at any time during the first 18 months of ownership to exchange the variable life insurance policy for a fixed benefit policy with the same coverage. *Id.* § 3f.

Withdrawal and free-look rights recently proposed by the SEC to apply to the sale of variable life insurance contracts are set forth in SEC Investment Company Act Release No. 9104 (Dec. 31, 1975). The SEC free-look proposal follows the NAIC approach but adds the requirement that notice be given. The free-look period runs until 45 days after the application is executed, 10 days after receipt of the contract, or 10 days after notice of the free-look right is mailed, whichever is later. The SEC proposal also grants a refund right to variable life insurance purchasers who purchase a contract sold with a front-end load and then withdraw during the first 30 months of the contract. The refund right requires that a sliding scale of excess sales load be refunded. Under the scale, loads in excess of 30 percent must be refunded if surrender occurs during the first 12 months. The permissible load charge decreases to 15 percent at the 30th month.

187. *See* note 165 *supra* and accompanying text.

by the present wide usage of nonvested commissions. Though section 6 of S. 2065 would prevent the "lock-in" effect caused by nonvested commissions, chances of enactment of the bill seem remote.[188] Aside from the federal legislation, however, there may be ethical and legal forces at work in the individual life insurance marketplace that could have an influence on the conduct of salespersons.

In terms of ethical conduct, a salesperson for a high cost company may well find it difficult to reconcile his or her station with the independence and fair-mindedness demanded for true professional status.[189] The practical difference that occasionally arises between the "is" of the real world and the "ought" of ethical behavior should not be an idle concern for those salespersons selling high cost policies who claim membership in professional organizations governed by codes of ethics stressing the need to put clients' interests first. There is in fact some question whether it is possible to reconcile the sale of policies costing materially more than equivalent substitutes with the ethical precepts espoused by some associations of life insurance salespersons.[190]

---

188. *Cf.* Gardner Address, *supra* note 30, at 19.

189. It is debatable whether any life insurance seller can lay claim to professional status where only one company's policies are offered or where compensation is by commission. *Cf.* note 163 *supra.*

190. The Code of Ethics for the National Ass'n of Life Underwriters, *reprinted in Life Insurance Hearings*, pt. 1, at 510, provides, among other things, that a member affirms it to be his or her responsibility:

> To keep the needs of my clients always uppermost. . . . To present honestly accurately and completely every fact essential to my clients' decisions. . . . To keep myself informed with respect to insurance laws and regulations and to observe them in both letter and spirit.

The Preamble to the Code of Ethics states:

> The position of the Life Underwriter is unique in that he is the liaison between his client and his company. As a life insurance advisor he owes a high professional duty toward his client, while, at the same time, he also occupies a position of trust and loyalty to his company. Only by observing the highest ethical balance can he avoid any conflict between these two obligations.

Members of the College of Life Underwriters also have an obligation to put clients' needs ahead of financial gain. *See The C.L.U. Pledge and Cost Standings*, PROBE, Jan. 15, 1973, at 3:

> The Pledge, as we all know, is essentially that "I will serve my clients in the same manner that I would want for myself if our positions were reversed." Does that permit a C.L.U. to sell a policy he knows to be more costly than others that are available? We think not. . . .
>
> . . . .
>
> We think the Pledge . . . is being violated every time a C.L.U. knowingly sells a high cost policy. (We are assuming of course, that every C.L.U. is aware of the cost standing of the company he represents.)

Apart from concern over ethical constraints, someone who sells high cost policies has reason to consider possible legal obligations. The basic question is whether the sale of a high cost policy without disclosure of materially less expensive alternatives[191] of equal quality will give rise to a cause of action in favor of the purchaser. It is unlikely that courts will provide uniform answers

For a discussion concluding that the disciplinary "enforcement machinery [of the American Society of Chartered Life Underwriters] is a sham, and that its Code of Ethics is a public relations gimmick," see Belth, *Observations on the Enforcement Machinery of the C.L.U. Code of Ethics*, J. RISK & INS., Mar. 1974, at 171.

191. It is recognized that there can be gradations within the materiality category. For example, in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the Court stated that, for purposes of rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), "[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision." 406 U.S. at 153-54. In another securities laws context it has been held that the test for materiality is

> whether "taking a properly realistic view, there is a *substantial* likelihood that the misstatement or omission may have led a stockholder to grant a proxy to the solicitor or to withhold one from the other side whereas in the absence of this he would have taken a contrary course" . . . .

Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973) (stating the test for materiality under rule 14a-9, 17 C.F.R. § 240.14a-9 (1975)). *Contra*, Northway Inc. v. TSC Indus., Inc., 512 F.2d 324, 332 (7th Cir. 1975), *cert. granted* 96 S. Ct. 33 (1975) (concluding that the proper test in rule 14a-9 cases is "whether the omitted fact is of such a character it might have been considered important by a reasonable shareholder who was in the process of determining how to vote"). According to the RESTATEMENT OF TORTS § 538(2)(a) (1938), the basic test of materiality is whether "a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question."

A court called on to determine the materiality of a misstatement or omission in connection with the sale of insurance might wish to consider the definition of materiality in CAL. INS. CODE § 334 (1972):

> Materiality is to be determined not by the event, but solely by the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries.

North Dakota has an identical statute, N.D. CENT. CODE § 26-02-17 (1970). The materiality test quoted is applicable to instances of concealment by insureds or insurers in California and North Dakota. *See* text accompanying note 199 *infra*.

Also pertinent to the materiality question is section 4(c)(2) of the UNIFORM CONSUMER SALES PRACTICES ACT, *reprinted in* 1971 HANDBOOK OF THE NAT'L CONF. OF COMM'RS ON UNIFORM STATE LAWS 184, 190. That section outlaws sales where the price paid grossly exceeds the price charged for equivalent items elsewhere. A transaction involving a 300 percent variation is given as an illustration of an "unconscionable" price differential. Section 4(c)(2) is discussed further at note 212 *infra*.

It was noted earlier that very substantial price differences have been found between whole life insurance policies. *See* note 47 *supra* and accompanying text. Differences of the magnitude there noted (up to 170 percent) would seem to be material, even if they might not fall into the "unconscionable" category.

to that question because of the differing ways life insurance is marketed.

Life insurers use a wide variety of distribution systems, ranging from direct response mail solicitation to personal selling. Within the personal selling category there is a spectrum of distribution arrangements extending from use of sales personnel who sell only one company's line to reliance on persons who offer a broad range of competing products. In agency law terminology, the one-product retailer is typically viewed as the company's agent, while the multi-line seller (called a "broker") generally has the customer for a principal.[192] Within these two basic categories there is room for distinguishing between sales personnel on the basis of their representations of independence or special expertise.[193] A court can be expected to evaluate the positions of the parties carefully. Where the customer knows the salesperson sells only one product, a court should not be expected to grant rescission or damages merely because of a failure by the salesperson to disclose the existence of comparable coverage available at a cheaper price. The result may be different for a broker who is a self-proclaimed insurance expert and who sells a high cost policy to a trusting client without disclosing low cost alternatives available from equally good companies. A number of sources, including basic agency law, indicate that there may conceivably be a cause of action against the broker in such a case. To the extent a broker enters into an agency relationship with a client, the broker assumes the duties of service, obedience, and loyalty which are inherent in that relationship.[194] One duty common to all agency

192. *See* J. O'CONNOR, LIABILITY OF INSURANCE AGENTS AND BROKERS (1970); Alsobrook, *Liability of Insurance Agents and Carriers' Exposure Contrasted with Liability Incurred by Brokers and Malpractice Aspects*, in 1968 PROCEEDINGS OF ABA SECTION OF INS., NEG. & COMPENSATION LAW 502-03; Hume, *Errors and Omissions Liability as Affecting Insurance Agents and Brokers*, 40 INS. COUNSEL J. 379, 380 (1973). The distinction is not always consequential:

> One thing is clear. The courts do not draw any fine distinctions between agents and brokers in imposing liability. It is well recognized that many are both agents and brokers; that a broker is often acting as an agent for the insurer; and that an agent may have direct obligations to the insured whether he is licensed as an agent or not.

Levit, *The Liability of an Insurance Broker or Agent — Updated*, 1974 INS. L.J. 207, 209.

193. *See generally* notes 197-212 *infra* and accompanying text.

194. These duties are spelled out in 2 RESTATEMENT (SECOND) OF AGENCY §§ 377-98 (1958). The nature of these duties is discussed in Introductory Note, *id.* at 171. It is there noted that the fiduciary relationship that is an essential part of the agency relationship calls for adherence to rules and assumption of obligations that transcend those found in

relationships is the agent's duty to give information to the principal. Section 381 of the *Restatement (Second) of Agency* provides:

> Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.[195]

This suggests that an insurance salesperson who functions as a broker may well have a legal obligation to alert a client to a material disparity in cost between competing offerings.

The idea is not as far-fetched as it might seem. A mild form of cost disparity disclosure is already required to be printed in a prominent position in mutual fund prospectuses[196] and, according

---

regular contractual relationships. The duties listed in the *Restatement* inhere in an agency relationship absent an agreement to the contrary. *Id.* § 376, comment *a*. Breach of a duty owed by an agent to a principal gives rise to a cause of action in tort by the principal (where loss is suffered) and a cause of action on the employment contract (assuming the agent is not a gratuitous agent). *See id.* § 401, comment *a*. There is a split of opinion as to whether a claim against an insurance salesperson for breach of duty gives rise to an action in tort or contract, or both. *See* Adkins & Ainley, Inc. v. Busada, 270 A.2d 135, 137 n.1 (D.C. App. 1970); J. O'CONNOR, *supra* note 192, at 10.

195. 2 RESTATEMENT (SECOND) OF AGENCY § 381, at 182 (1958). This duty parallels the duty of a trustee to furnish information to the beneficiary. *See* 1 RESTATEMENT (SECOND) OF TRUSTS § 173 (1959). As in the case of the agent's duty, the trustee's duty to give information can arise in the absence of a request for information by the beneficiary. *Id.* at comment *d*. The comment to section 381 notes that "[t]he extent of the duty depends on the kind of work entrusted to him, his previous relations with the principal and all the facts of the situation." 2 RESTATEMENT (SECOND) OF AGENCY § 381, comment *a* at 183 (1958).

196. SEC Investment Company Act Release No. 7220 (June 9, 1972). The release sets forth guidelines for forms S-4 and S-5 and provides that a legend such as the following should appear on the prospectus's front cover page or inside cover, bordered with a line:

> Numerous investment companies continuously offer their shares to investors. Investment companies have different investment objectives and techniques and involve varying degrees of risk. Sales commissions which are paid to compensate persons who sell investment company shares vary as do management charges and expense ratios. For the last fiscal year, the Company's total operating expenses including advisory fees were approximately ____ percent of average annual net assets.

The guideline amounts to a watered-down version of Dr. Irwin Friend's proposal that the SEC

> provide potential fund investors with "full disclosure" so that they are aware of the performance and costs of the funds offered to them compared with the broad alternatives which include other load funds, no-load funds and closed-end investment companies — the latter frequently selling at a discount.

University of Pennsylvania Law School Conference on Mutual Funds, 115 U. PA. L. REV.

to a recent securities law decision, stock brokers who hold themselves out as having greater than normal expertise are "obliged to suggest alternative investments . . . regardless of the effect on brokerage commissions."[197] An extension of such protection to cases where trust has been reposed is plainly in line with the tentative draft of section 551(2) of the *Restatement (Second) of*

669, 773-74 (1967) [hereinafter cited as *Mutual Funds Conference*] (remarks of Dr. Irwin Friend). Subsequent to raising his disclosure suggestion at the Pennsylvania Law School Conference, Dr. Friend advocated essentially the same arrangement before the Senate Banking and Currency Committee at the 1967 mutual fund hearings, *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 2, at 668 (1967). Two members of the Senate Committee, Senators Proxmire and Bennett, indicated their reservations concerning the proposal. Said Senator Proxmire:

> Is there really any industry in which this is required or done? Isn't this really going pretty far to ask somebody to advertise a competitor, to ask a Chevrolet salesman to come in and say what Ford is doing for a comparable amount, and Chrysler, and American Motors?

Id. at 678. Senator Bennett was more blunt, telling Dr. Friend: "I think you have proposed a theory that would destroy American business." *Id.* at 679.

A response to the general concern voiced by Senator Proxmire was made by one expert in the field of life insurance marketing as follows:

> Any proposed buyer enlightenment standard for life insurance should not be dismissed on the sole ground that it is not expected of automobile salesmen or in supermarkets. Among the weaknesses of such an attitude are:
>
> (1) the special relationship of trust which life insurance people presumably wish to foster with their clients;
>
> (2) the venue of the typical life insurance presentation — in the home of the prospective buyer;
>
> (3) the major financial decision that a life insurance purchase entails.

Testimony of E.J. Moorhead, *supra* note 140, Appendix, at 2.

197. Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975). One of the issues confronted in *Carras* was the liability of a broker for failure to warn about the risks of, and suggest alternatives to, a certain type of investment program. The district court held that liability for nondisclosure could be imposed on the broker only if fraudulent intent could be established. The jury found no fraudulent intent. Rejecting the idea that intent to defraud had to be shown, the appellate court held that whether the alleged misconduct "is actionable depends on the nature of [the broker's] relationship with [his client]." *Id.* at 256. The court then went on to distinguish the "special expertise" case from an instance where "he acted only as a broker." In this latter case, according to the court, "[h]e would be obliged to execute his customers' order faithfully, but not to volunteer advice." *Id.* at 257. The court proceeded to note that even when functioning merely as a broker: "If he did offer advice, he would be required by Rule 10b-5 not to mislead by knowing falsehoods or concealment of facts." *Id.* In making its subjective inquiry into the personal relationship between the defendant broker and his client, the circuit court followed the decision of the Court of Appeals for the Ninth Circuit in White v. Abrams, 495 F.2d 724 (9th Cir. 1974). The court in *White* adopted a flexible duty standard for use in 10b-5 cases. Additional authority could have been cited by the *Carras* court to support the proposition that a stockbroker's duty of candor varies according to the nature of the relationship with the client. *See* Cant v. A.G. Becker & Co., 374 F. Supp. 36, 47 (N.D. Ill. 1974); *cf.* Phillips v. Reynolds & Co., 294 F. Supp. 1249, 1255 (E.D. Pa. 1969).

Torts which provides in part:

> One party to a business transaction is under a duty to disclose to the other person before the transaction is consummated:
> (a) such matters known to him as the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.[198]

The basic principles of fair dealing implicit in these different sources are not wholly foreign to insurance marketing; statutes in California and North Dakota specifically vest an insured with a right to rescind the insurance contract where the insurer has withheld material facts about the contract.[199] Insurance case law also provides a basis for positing a duty by insurance sales personnel to disclose material differences in cost. Such individuals have come to be viewed as skilled professionals able to handle complex problems beyond the ken of lay-persons and upon whom the public may rely with confidence.[200] Like other groups capitalizing on

---

198. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (Tent. Draft No. 12, 1966). For cases where the duty embraced by the *Restatement* provision has been noted, see, *e.g.*, Klein v. First Edina Nat. Bank, 293 Minn. 418, 196 N.W.2d 619 (1972) (recognizing that a bank may have a duty to inform a customer of facts where the bank knows or has reason to know the customer is placing trust and confidence in the bank and is relying on the bank for counsel and information); Edward Barron Estate Co. v. Woodruff Co., 163 Cal. 561, 126 P. 351 (1912) (finding a duty of disclosure on the part of an architect who was in a relationship of agency and "trust and confidence" with plaintiffs); *cf.* note 206 *infra* and accompanying text.

199. *See* CAL. INS. CODE §§ 331-33 (1972); N.D. CENT. CODE §§ 26-02-14 to -16 (1970). The statutes are virtually identical. *See* note 191 *supra* for the definition of materiality used in connection with the concealment provisions. For discussion concerning California's concealment statute, see Patterson, *Some Contract Provisions of the California Insurance Code*, 32 S. CAL. L. REV. 227, 234-36 (1959); Comment, *Insurance: Concealment and Misrepresentation as Grounds to Avoid Policy*, 5 U.C.L.A. L. REV. 332 (1958). According to Patterson:

> No insured has, as far as the present writer's study of insurance cases for forty-three years has revealed, ever attempted to *avoid* a contract of insurance because of the insurer's concealment . . . .

Patterson, *supra* at 669. Of course, the fact that the right has not been exercised does not mean it does not exist.

200. *E.g.*, Anderson v. Knox, 297 F.2d 702, 706 n.4 (9th Cir. 1961); Hardt v. Brink, 192 F. Supp. 879, 881 (W.D. Wash. 1961); Levit, *supra* note 192, at 207; Redenbaugh, *Liability Considerations Concerning Insurance Agents and Brokers*, 22 DRAKE L. REV. 738 (1973). It has been suggested that "agents and brokers will be held to the standard of a professional. Those who advertise themselves as specialists will probably be held to an even higher standard of care." Levit, *supra* note 192, at 210. This two-step view is consistent with conventional tort and agency theory. *See* 2 RESTATEMENT (SECOND) OF TORTS § 299A, comment *d* at 74 (1965); 2 RESTATEMENT (SECOND) OF AGENCY § 379, comment *e* at 179 (1958).

the increased complexity of modern times to expand their influence, insurance agents and brokers have been expected to assume the risk of increased accountability for their actions,[201] particularly when they have held themselves out as trustworthy experts.

In *Anderson v. Knox*,[202] the Ninth Circuit affirmed a holding of liability and the assessment of punitive damages against a life insurance agent who had sold a policy that was unsuitable for his customer. In upholding the verdict for the plaintiff the court found it "interesting" that the code of ethics to which the defendant subscribed referred to insurance purchasers as "clients,"[203] and the court went on to point out that the defendant had represented himself as "an expert . . . and a man upon whom Knox could rely for information about what he was buying."[204] The court reached its holding of liability without having to assume the defendant was in an agency relationship with the plaintiff.[205] This same sort of "holding-out" reasoning prompted another court to impose liability on an insurance retailer who failed to convey relevant information where it was "clear that through the designations on his letterheads and the stickers he attached to policies issued by his office defendant held himself out to be an insurance expert."[206] Complementing the pro-policyholder themes of these

201. *See, e.g.*, Neel v. Magana, Olney, Levy, Cathcart & Gelfand, 6 Cal. 3d 176, 194, 491 P.2d 421, 432-33, 98 Cal. Rptr. 837, 848-49 (1971) (dealing with lawyers' liability); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 450.

It is significant that in a leading "professionalism" case involving an insurance transaction the court observed that:

> The law here involved is not particularly startling nor is it necessarily an extension over previous cases. This is an age of specialists and as more occupations divide into various specialities and strive towards "professional" status the law requires an ever higher standard of care in the performance of their duties.

Hardt v. Brink, 192 F. Supp. 879, 881 (W.D. Wash. 1961).

202. 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962), *aff'g* 159 F. Supp. 795 (preliminary decision), 162 F. Supp. 702 (formal findings of fact and conclusions of law) (D. Hawaii 1958).

203. Anderson v. Knox, 297 F.2d 702, 706 n.4 (9th Cir. 1961). The court focused on the ethics issue because the defendant agent held himself out on his letterhead as a member of the National Association of Life Underwriters, an organization of life insurance sales personnel which has its own code of ethics. *See* note 190 *supra*. The court also found it significant that insurance agents are licensed by the states. The court opined that "it is conceivable that one who is thus licensed is by virtue of that fact made to assume duties toward purchasers comparable to the fiduciary obligations of lawyers and physicians." 297 F.2d at 706 n.4.

204. 297 F.2d at 710.

205. *Id.* at 706 n.4.

206. Hardt v. Brink, 192 F. Supp. 879, 881 (W.D. Wash. 1961). The court in *Hardt*

cases are other decisions recognizing brokers owe a duty to provide their clients with the best coverage available at the most favorable rate.[207]

Taken together, these authorities suggest legal problems may be in store for life insurance salespersons, particularly brokers, who sell high cost policies without disclosing the existence of low cost alternatives. The risk of liability would seem to be especially great where, for reasons of self-esteem and attracting clients, the salesperson has projected the image of one who is a highly skilled and trustworthy professional.[208] This image of professionalism

---

assumed that there was an agency relationship between the agent and the client. However, this was not critical to the holding, because the court took the position that "[n]o affirmative duty to disclose is assumed by the mere creation of an agency relationship." *Id.* at 880. *But see* text accompanying note 195 *supra.* The court went on to find a duty to disclose based on the facts before it, including particularly the defendant's representations of special expertise. A similar view, focusing on an imbalance in information, was taken by the court in Steadman v. McConnell, 149 Cal. App.2d 334, 308 P.2d 361 (1957), where the court upheld the suspension of an agent's license on the basis of misrepresentation, dishonest conduct, incompetency and untrustworthiness. The court in *Steadman* observed that:

> The appellant was an expert in the field; the insured a mere layman who was led to believe the bank plan would meet certain expressed objectives. Certainly the relationship was a fiduciary one in which Mr. and Mrs. Stokes were entitled to believe appellant's material statements.

Id. at 339, 308 P.2d at 365.

207. *E.g.*, Roberts v. Sunnen, 38 Wash.2d 370, 229 P.2d 542 (1951) (salesperson sued for failure to advise client that $100 deductible rider could be obtained; suit dismissed when client failed to prove rider was available); Colpe Inv. Co. v. Seeley & Co., 132 Cal. App. 16, 22 P.2d 35 (1933) (cause of action stated where insured alleged and presented testimony that defendant failed to procure coinsurance clauses attaching to certain policies, thereby causing plaintiff insured to overpay for coverage). *See also* J. O'CONNOR, *supra* note 192, at 14; Morrison, *The Anomalous Position of the Insurance Agent — An Invitation to Schizophrenia*, 12 VILL. L. REV. 535, 540 (1967). *But cf.* 3 G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 25:55, at 363 (2d ed. R. Anderson 1960).

A concomitant of the duty to provide the best coverage at the best rate is the obligation "to know the different companies and the terms available." 16 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 8831, at 453 (1968). This duty of diligence has been held applicable to brokers. *See* Colpe Inv. Co. v. Seeley & Co., *supra.*

208. An aura of professionalism may be useful in attracting business. A brochure published by the American Society of Chartered Life Underwriters offers a handsome C.L.U. "Pledge Plaque" for display by members. The brochure states:

> Ready now for your order is the new C.L.U. Pledge Plaque, designed to combine a feeling for our traditions with an awareness of our present. It's a handsome, boldly-stated, uncluttered, easily-read way to let your clients and friends know that you operate with the highest professional commitment. Framed so that it can be hung on any wall - or stood on a desk or table or a bookshelf. In your office or in your home. At $15.00, it may be the least expensive public relations campaign you have ever launched.

American Society of Chartered Life Underwriters Brochure on file with *South Carolina Law Review*.

should carry the price tag of a duty of full and fair disclosure of all material facts to clients, and cost may be one such material fact if the gap in price between competing policies is great.

Disclosure systems like that embodied in the Model Regulation arguably provide sufficient notice of cost differences to put the uninitiated on their guard. But the inherent complexity of the product being sold may discourage cost comparisons by consumers[209] and may well be taken by a court as a reason for

---

209. As indicated earlier, many policyholders appeared to see no reason to go beyond their agents' representations for additional information about insurance. *See* note 164 *supra*. Part of the reason for this may be that insurance policies and their terminology are not easy for prospects to read or understand.

This conclusion was indicated by tests conducted by the Pennsylvania Insurance Department based on a readability test developed by Rudolph Flesch. The test technique is based on the average number of words per sentence and the average number of syllables per word. Results usually range from 0 to 100 with 100 being the most readable. A readability comparison presented by Pennsylvania's Insurance Commissioner at the life insurance hearings is set forth below:

Source	Flesch reading ease score	Readability characteristic	School grade level
"Baseball is a Funny Game" by Joe Garagiola	80.17	Easy	5th grade
"The Bible", revised standard version	66.97	Standard	7th or 8th grade
Time magazine	52.30	Fairly difficult	Some high school
"Economics: Principles and Applications" by Paul Samuelson	43.84	Difficult	High school, some college
The Wall Street Journal	43.39	. . . do . . .	Do.
Northwestern mutual life policy (H.H. series)	34.56	. . . do . . .	Do.
Blue Shield 65-special policy (medicare supplement)	26.82	Very difficult	College
Blue Shield 100 policy (basic medical coverage)	23.39	. . . do . . .	Do.
"The Meaning of Relativity" by Albert Einstein	17.72	. . . do . . .	Do.
Standard automobile insurance policy	10.31	. . . do . . .	Do.

Life Insurance Hearings, pt. 3, at 1540.

positing a strong duty of candor on the sellers of high cost policies.[210] Moreover, the public has been conditioned to rely on sales personnel,[211] and a court may thus not be willing to excuse a salesperson where the client is never informed that a material cost disparity exists between the policy purchased and a low cost policy written by a reputable competitor.[212]

In light of the readability scores, it should not be surprising that nearly three out of four respondents to a recent national survey of consumers' attitudes regarding life insurance reported having difficulty understanding "the terminology used in life insurance policies." INSTITUTE OF LIFE INSURANCE & LIFE INSURANCE MARKETING & RESEARCH ASS'N, LIFE INSURANCE CONSUMERS: NATIONAL SURVEY OF COST COMPARISON ATTITUDES AND EXPERIENCE 12 (1975). Apart from problems that may be encountered in trying to understand what a policy says, prospects inclined to develop their own cost comparisons may be at a disadvantage, because "[t]o derive and check the twenty-year Interest-Adjusted Costs of two participating policies entails punching more than 160 numbers into the typical desk calculator. . . ." Address by Peter Ryall, Society of Actuaries Annual Meeting, Nov. 11, 1970, *reprinted in Life Insurance Hearings*, pt. 1 at 762, 766. In view of these difficulties with readability and computation, it is difficult to quarrel with the appraisal that: "Comparison shopping for life insurance requires a degree of patience (masochism?) and a fondness for mathematics well beyond normal human capacity." FORBES, Sept. 1, 1975, at 72-73.

210. *Cf.* McCarthy v. Cahill, 249 F. Supp. 194, 195 (D.D.C. 1966) (release given to client by agent and signed held invalid even though client had not read it, with the court indicating that proof of independent inquiry by the client is not necessary where making it would be "expensive, difficult, or demand a certain amount of expertise not possessed by the party"); Anderson v. Knox, 159 F. Supp. 795, 806 (D. Hawaii 1958) ("The complexity of the insurance plan sold to plaintiff brings us into an area of the law which has long since seen the demise of caveat emptor."); Steadman v. McConnell, 149 Cal. App. 2d 334, 339, 308 P.2d 361, 365 (1957); Comment, *Insurance Agent's Duty to Make a Fair Disclosure*, 43 MINN. L. REV. 1001, 1002 (1959).

211. For example, an advertisement sponsored by the Independent Insurance Agents of America, Inc. carries the headline "How to Get the Best Insurance Buy for Your Money," and informs that an "independent agent" can be counted on to provide "the best insurance coverage at the lowest true cost to you." TIME, Mar. 15, 1976, at 65. It is arguable that customer reliance on sales personnel will be increased rather than lessened by mandatory disclosure of large amounts of data. It has been theorized that the consumer's confidence in his or her salesperson is enhanced rather than diminished by every effort the salesperson makes to give the client the information needed to make an intelligent choice when buying insurance. *See* Minutes of NAIC Task Force Meeting of June 3, 1974, attachment 1, at 3 (quoting Virginia Knauer).

212. In assessing the propriety of the agent's action in a case involving a material cost disparity, a court might well consider the terms of the UNIFORM CONSUMER SALES ACT, *reprinted in* 1972 HANDBOOK OF THE NAT'L COMM'RS ON UNIFORM STATE LAWS 184. Among other things, section 4(c)(2) of the Act requires courts judging claims of unconscionability in the sale of goods and services to consider whether "when the consumer transaction was entered into the price grossly exceeded the price at which similar products or services were readily obtainable in similar transactions by like customers." Section 2(b) of the Act expressly makes inclusion of securities transactions in the Act's coverage optional with the adopting state; however, nothing is said about exempting insurance sales. Kansas, Ohio, and Utah are the only states to have enacted a version of the law. 7 UNIFORM LAWS ANNOT.

The threat of civil litigation may thus lead to the increased willingness of salespersons to comment on cost disparities and, hopefully, to seek out and offer low cost products. Whether the spectre of civil liability will furnish substantial assistance in promoting such actions is open to doubt, however, since potential recovery for breach of duty by sales personnel will rarely exceed the costs of litigation. Moreover, success in a nondisclosure case of this sort is far from assured. Despite some indications that the law is poised to move in the direction of full disclosure, there is no guarantee that any court will enter an order that would have the precedential effect of requiring a salesperson to extol the virtues of a competing product.

In light of these considerations, regulatory and legislative action may well be more fruitful sources of pressure for full and fair disclosure. It is hence surprising that the Model Regulation declares in its buyer's guide that a "good agent" will be willing and able to explain differences in costs and coverages,[213] without attempting to put direct pressure on sales personnel to do so.[214] The Hart bill's disclosure scheme lacks even so quiet a reference to sales personnel as a source of information. Hopefully, future consideration of either proposal will include debate over the efficacy of promulgating guidelines aimed at prompting sales personnel to discuss cost disparities when making their sales presentations.

F. *Reform and Insurance Company Managements*

The agency distribution system used to market individual

212 (Supp. 1975). Each statute expressly exempts both securities and insurance activity from the statute's purview. *See* KAN. STAT. ANN. § 50-624(c) (Supp. 1974); OHIO REV. CODE ANN. § 1345.01(A) (Page Supp. 1974); UTAH CODE ANN. § 13-11-3(2) (Supp. 1973).

213. MODEL REGULATION, Appendix, at 10 (Dec. 9, 1975) (temporary draft). The statement in the buyer's guide parallels the declaration in a booklet cosponsored by the National Association of Life Underwriters that a high-quality life insurance salesperson "is willing to explain the cost and coverage differences among companies." NATIONAL ASSOCIATION OF LIFE UNDERWRITERS & LIFE INSURANCE MARKETING & RESEARCH ASS'N, YOU AND YOUR LIFE INSURANCE AGENT 3 (1974). *Cf.* note 211 *supra*.

214. Apparently the drafters of the Model Regulation viewed matters of sales force professionalism as outside the scope of their inquiry. Telephone interview with Daniel D. Andersen, January 20, 1975. This may explain why the final draft of the regulation omits a suitability requirement present in earlier drafts. *See* MODEL REGULATION § 8(d) (draft of June 10, 1975). That provision was patterned after WIS. AD. CODE § INS 2.14(4) (1974), which was in turn patterned after the suitability requirement imposed on securities salespersons by the National Association of Securities Dealers' Rules of Fair Practice. *See Life Insurance Hearings*, pt. 2, at 955-56 (testimony of S.C. DuRose).

life insurance has been called the "Achilles' heel" of the life insurance industry, reflecting "high cost to the policyholder, the high cost of agent turnover, of lapses, and of policy switching."[215] The facts bear out this assertion. On the subject of sales force turnover, it has been estimated that of "all our people currently being hired into the Agency System, only 11 percent of them will still be in it five years from now."[216] It has also been said that the life insurance industry "spends $1 billion a year on agent turnover, has been doing it for years, and things are getting worse."[217]

The cost of lapsation is likewise substantial. According to a rough estimate prepared by the staff of the Senate Antitrust and Monopoly Subcommittee, the loss to policyholders on whole life insurance policies issued in 1970 and dropped in 1970 and 1971 was over $500 million.[218] Calculations by the subcommittee staff

---

215. *Life Insurance Hearings*, pt. 1, at 39 (statement of Michael P. Walsh). Payment for marketing effort is an expensive proposition for companies and policyholders. It has been estimated that 98 cents of the average social security payment dollar is returned in the form of benefits; the figure is 85 cents in "the private life insurance industry taken as a whole." For certain types of policies, the figure is 35 cents. 121 CONG. REC. S 11,982 (daily ed. July 8, 1975). Consumers Union makes this same sort of analysis but gives lower returns. *See* THE CONSUMERS UNION REPORT ON LIFE INSURANCE 39 (2d ed. 1972) ("97 cents of the social security dollar is returned in the form of benefits, compared with only about 55 cents of the average life insurance premium dollar."). Of course, the wide gap that may exist for many companies between premiums paid and benefits received by policyholders is not due solely to marketing costs. There are other types of deductions that may be involved, such as profit earned by stock companies.

216. *Life Insurance Hearings*, pt. 1, at 39 (statement of Michael P. Walsh). Studies made by the staff of the Senate Antitrust and Monopoly Subcommittee showed an attrition rate for 35 large companies averaging approximately 88 percent over 5 years. *Id.*, pt. 4, at 2588-2600. The Senate study did not attempt to determine numbers of agents transferring to other companies. *See id.* at 2257.

217. *Id.* at 10 (written statement of Ralph Nader). One life insurance executive is reported to have stated that despite hiring and training about 20,000 new agents by his company over 10 years, the size of the company's sales force *decreased* by 200 agents over the period. Greenberg & Greenberg, *Predicting Sales Success—Selecting Top Producers*, BEST'S REV., May 1975, at 32 (Property ed.).

218. *See Life Insurance Hearings*, pt. 1, at 208-11. The staff's math is suspect. The result assumes loss based on payment of a full year's premium on a whole life policy by a lapsing policyholder, with the loss for each policyholder equalling the difference between the amount paid and the amount term coverage would have cost. However, according to a later study by the staff, the average duration of policies lapsed during the first 13 months of ownership for many companies was less than 6 months, not a full year as had been assumed. See answers to item 6(b) on questionnaires set forth in *Life Insurance Hearings*, pt. 4, at 2905-91. This indicates that the loss may be a good deal less than the staff estimated. Even so, the cost is substantial. When introducing S. 2065, Senator Hart made reference to a study which showed that 13-month lapsation cost 1971 purchasers of 31 companies' cash value policies roughly $55 million. 121 CONG. REC. S 11,976 (daily ed. July 8, 1975).

based on a questionnaire sent to various companies produced an "industry average" 13-month lapse rate for new policyholders of 17.2 percent,[219] a rate high enough to suggest the presence of overselling and inadequate post-sale service.[220] Moreover, the harm inflicted by these deficiencies falls not only on the possibly ill-served terminating policyholders who have built up little or no cash value at the time of lapse, but also on salespersons who lose a source of post-sale commissions, and on companies (and, indirectly, on nonlapsing policyholders) whose expenses during the first year normally exceed the first year's premium.[221]

Wasteful policy switching or "replacement," the final manifestation of the Achilles' heel syndrome mentioned above, is related to the lapse problem and can be taken as evidence of consumer ignorance and a lack of sales force professionalism.[222] Improved disclosure methods may help educate prospects to the point that they are able to choose a policy that is not only less

219. *Life Insurance Hearings*, pt. 4, at 2886. The tabulation lists responses from 55 companies. The highest first year lapse rate reported was 41.8 percent for Interstate Life and Accident; the lowest rate was 8.0 percent for Northwestern Mutual. These and other staff findings on early lapsation were very much on Senator Hart's mind when he introduced S. 2065. Senator Hart pointed out in the course of his speech that a

> 52-percent [thirteen month] lapse rate came from one of the biggest selling cash value policies of a company whose name could certainly be considered a household word. It is very high — but not the highest showing up in the study. For 59 of the largest companies, on average, about 18 percent of all straight life policies sold are lapsed by the consumer within the first 13 months. . . .
>
> However, average industry figures for all policies sold do not sufficiently indicate just how high early lapse rates are. A better indicator is the 13-month lapse rate of the biggest selling cash value policy of each company. For instance, of 148 companies surveyed by the subcommittee, one out of four policyholders of 64 companies dropped the best selling policy within 13 months after buying it in 1971. Fifteen of these companies had unbelievably high early lapse rates ranging from 40 to 50 percent.

121 CONG. REC. S 11,976 (daily ed. July 8, 1975).

220. *See* White, *Cost Disclosure and Comparisons — The Direction of Emerging Requirements*, BEST'S REV., Aug. 1975, at 26, 28 (Life ed.); *cf.* Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058, 1070 (1967) (referring to implications that may be drawn from high lapse rates by holders of mutual fund contractual plans).

221. *See Life Insurance Hearings*, pt. 4, at 2254 (testimony of Alfred G. Whitney). With respect to losses to companies it has been estimated that the "combined expenses that are incurred only at the time of issue [of a whole life insurance policy] can be assumed to equal at least 110 percent of the first premium." D. MCGILL, LIFE INSURANCE 253 (1962).

222. *Cf.* Statement of the IDS Life Insurance Co. to the NAIC Life Insurance and Cost Comparison (C3) Task Force, Apr. 20-21, 1975, at 8; *Life Insurance Hearings*, pt. 2, at 1322 (testimony of Virginia Knauer).

expensive but also suitable for their needs. If so, disclosure would assist in preventing uneconomic switching and lapsation.

While disclosure could lead to more intelligent shopping thereby saving companies and policyholders money by cutting lapses and replacements, it is clear that the chief foreseeable effect of an effective disclosure and cost comparison system will be to increase price competition which in turn will reduce cost to the public. Price reductions may lead to increased volume. At the same time, price cuts may put pressure on insurers' margins. If falling margins force "fat" to be trimmed from company budgets, affected companies will probably want to reappraise the efficiency of a distribution system that evolved in a time when the marketplace was less price conscious.

There are many things managements bent on self-improvement, and self-protection,[223] should consider. For example, the lapsation embarrassment cries out for action.[224] Managements may wish to adopt special information programs to warn prospects and new policyholders about the risk of loss posed by

---

223. On the existence of an affirmative duty to oversee marketing effort, *cf.* Mundheim, *supra* note 220, at 1068-70 (suggesting that mutual fund directors have an obligation to supervise various aspects of mutual fund distribution). As is the case with mutual funds, continuing sales of life insurance to new prospects are necessary if the business is not to shrink in size. This suggests a crictical relationship between marketing skill and business success and gives reason for insurance company directors to take a special interest in promoting efficiency in the company's marketing effort. This need for fresh concern over the marketing aspects of the business at the highest echelons of insurance company management was highlighted at the life insurance hearings by Mr. S.C. DuRose, then Chairman of the NAIC Cost Comparison Task Force:

> For years, many companies have asserted that, under the legal reserve life insurance system, one company is as good as another. . . . Experience has taught us that, as between companies, the quality of management differs. Some companies have more economical systems of sales distribution. Some pay lower rates of commission. Some companies are more selective in their underwriting than others. Some companies aim their selling efforts at different markets, e.g. blue-collar workers v. professionals and entrepreneurs. These differences are reflected in the cost of the policies which they sell, the policy terms, and the caliber of the service which they and their agents render.

Life Insurance Hearings, pt. 2, at 916. The crucial point is that it is reasonable to view supervision of distribution as a management function and, in egregious cases, "inefficient distribution" may be translated into "mismanagement" with all of the serious legal consequences that dereliction of duty entails.

224. Arguing in favor of measures specifically aimed at minimizing early lapses is the apparent willingness of state insurance commissioners to review variable life insurance lapse statistics for evidence that a company and its agents engage in unsuitable sales "as a general business practice." *See* NAIC MODEL VLI REGULATION, art. III, § 3. The prospect of a similar study being made of regular life insurance lapse rates should worry some managements. *Cf.* note 219 *supra*.

early lapse. Another angle of attack on the lapsation problem would be to provide disincentives for overselling, such as forfeiture of commissions. Managements of companies that choose to market policies which are substantially more costly than similar policies written by other companies will want to be assured by counsel that price distinctions are not so extreme as to expose sales personnel to charges of unethical conduct or breach of a duty to disclose in the event prospects are not alerted to low cost alternatives. Obviously, if counsel finds that there is a duty to disclose, the sales force should be promptly advised.[225] High cost companies will also want to monitor closely sales force turnover in the face of mandatory disclosure to see if price competition may be occurring which has an adverse impact on the company's marketing efforts. Low cost companies will want to assure that the low cost selling point is exploited but not abused. In part, this means sales personnel must be trained in calculating whether

225. This effort to make inquiry of counsel and give notice to agents takes on heightened importance in view of what has been perceived as "an increasing tendency of appellate court decisions to hold an insurance company liable for the representations of its agents." Whitford & Kimball, *supra* note 63, at 720. Apart from vicarious liability, there is the chance that an aggrieved policyholder could sue the company directly for its failure to properly supervise an unguided agent. The duality of these grounds for relief is well established in securities law. For example, in SEC v. First Securities Co., 463 F.2d 981 (7th Cir. 1972), a brokerage company was held liable for the fraud of its president. Among the different remedial theories pressed by plaintiff and accepted by the court were vicarious liability under agency law and breach of duty to supervise under section 27 of the NASD's Rules of Fair Practice. CCH NASD MANUAL ¶ 2177 (1975). On the latter point, see Comment, *Civil Liability for Violation of NASD Rules: SEC v. First Securities Co.*, 121 U. PA. L. REV. 388 (1972). The implication of the private right of recovery for breach of duty to supervise under the NASD's rules is of more than passing moment for insurers. Many NASD members sell insurance, and it has been held that unprofessional conduct by an NASD licensed registered representative in the sale of insurance can be a violation of the NASD's Rules of Fair Practice. *See* Thomas E. Jackson, SEC Securities Exchange Act Release No. 11476 (June 16, 1975). Since the duty to supervise for NASD members under section 27 includes a duty to, *inter alia*, "supervise properly . . . to assure compliance . . . with the rules" of the NASD, there is room for argument that insurers who are NASD members may be liable under section 27 for salesperson misconduct in insurance sales where the salesperson is an NASD registered representative and where the injury might have been avoided had the company more carefully supervised the salesperson. This is not to say that state insurance law would not support a cause of action against the company in such a case; the indications are the other way. *Cf.* Harr v. Allstate Ins. Co., 54 N.J. 287, 305, 255 A.2d 208, 219 (1969):

> If the insurer is saddled with coverage it may not have intended or desired, it is of its own making, because of its responsibility for the acts and representations of its employees and agents. *It alone has the capacity to guard against such a result by the proper selection, training and supervision of its employees.*

(Emphasis added.)

policy replacement is in a prospect's best interest. Also, such companies will want to determine the extent to which broad consumer acceptance alters the company's marketing mix. It has been noted that "a mass shift [of buyers] to the low-cost companies might increase their costs."[226]

Managements willing to take a hard look at their marketing system will also wish to consider the feasibility and desirability of reducing the cost of life insurance to their own policyholders for subsequent sales of policies to them. In the somewhat analogous case of the mutual fund industry, it has been noted that fund shareholders themselves provide an attractive market for the sale of fund shares.[227] This has led to some interest in cutting commissions on repeat sales. The justification for allowing price cuts is that repeat purchasers are in demonstrably less need of personal selling effort after they have once been sold and have held a given fund's shares.[228] One commentator has even gone so far as to state that "much mutual fund investing is effected by persons who already hold shares, and it is clear that directors representing their interests should seek to reduce the cost of further investments."[229] As was noted earlier, some life insurance companies

226. *Life Insurance Hearings*, pt. 2, at 1101 (testimony of Professor Spencer Kimball).

227. *See* PLI, MUTUAL FUNDS 409 (1970) [hereinafter cited as MUTUAL FUNDS] (remarks of Professor Robert H. Mundheim); PUBLIC POLICY REPORT 216; Lawson, *Communicating the Mutual Fund Message through Advertising*, INVESTMENT COMPANY INSTITUTE, 1974 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 93; *cf.* Distribution Hearings Transcript 1119 (remarks of George Washburn). A survey conducted in 1970 found that mutual fund industry assets were held by over 8 million shareholders. INVESTMENT COMPANY INSTITUTE, 1975 MUTUAL FUND FACT BOOK 34.

228. *See* notes 335-38 *infra*.

229. Comment, *Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgement?*, 1972 DUKE L.J. 429, 443. This view would seem to have special application in the case of mutual companies where policyholders are actually the owners of the business. A sales compensation structure that makes these policyholders pay high sales loads for personal selling effort they do not need may not be operating in their best interest. Company managements might thus wish to consider the feasibility of alternative means of marketing to policyholders. It might be possible for sales to be made through use of low cost mass merchandising techniques that would eliminate the need for any personal selling. This is not to deny that there may be significant differences between the nature and extent of duties owed to policyholders and mutual fund shareholders by the managements of their respective companies. There surely may be such differences. *See* Hetherington, *Fact v. Fiction: Who Owns Mutual Insurance Companies*, 1969 WIS. L. REV. 1068, 1086-87 (contrasting the status of a shareholder with that of a mutual company policyholder in terms of duties owed by management). Still, it would seem that a management will wish to weigh the values of alternative means of marketing its product most efficiently. Mass marketing to policyholders holds the potential for generating economies

have already made "all in the family" reduced cost offerings of life insurance to employees, thereby implicitly recognizing that cost discrimination may be fair and legal when there is little or no need for personal sales effort.[230] This precedent, the parallel development of intrabrand price variation in the fund industry, and the obvious distribution economies that might accompany a mass marketing program aimed at existing policyholders should encourage insurance company managements to consider the feasibility of making reduced price sales to policyholders.

Among other areas a conscientious management will want to examine the extent to which: (1) the company's lapse rates and distribution expense ratios are in line with those for other companies serving similar markets; (2) promotional literature is current, complies with applicable statutory or regulatory requirements, and is consistent with the company's overall marketing strategy; (3) policy forms contain any structures resulting in the nonuniform progression of values;[231] (4) adequate sales force supervision is forthcoming from regional offices and company headquarters; (5) compensation structures and levels are competitive and, particularly in the case of compensation for post-sales services, merited; and (6) disclosure forms have been reviewed by legal counsel.

IV. PRODUCT PRICING AND THE MUTUAL FUND INDUSTRY

A. *Introduction*

From the preceding section it is apparent the life insurance market is not characterized by vigorous price competition. Intrabrand price competition has been stymied by statutory law that limits price differences for a given company's policies as between like classes of customers, and interbrand price competition is nearly nonexistent due to the inability or unwillingness of customers to appraise alternatives open to them. The one type of competition that is vigorous involves companies competing with

---

of distribution that may be partially shared with policyholders through reduced prices. Therefore, it should be considered.

230. *See* note 68 *supra*.

231. As was noted earlier, the NAIC recently reported that through use of sophisticated methods of policy analysis, "highly undesirable structures" have been found in many policy forms already passed on favorably by state regulators. *See* note 125 *supra*. Managements will want to require that the company's actuaries apply this learning to assure the fairness in structure of policy forms issued.

each other for sales force favor. All of this has a familiar ring for anyone acquainted with product pricing in the mutual fund industry.

As in the case of life insurance companies, there is some statutory restraint on intrabrand price competition for mutual fund shares. The statute in question, section 22(d) of the Investment Company Act of 1940,[232] is "the only mandatory federal fair trade law on the books."[233] It bars mutual fund dealers from selling fund shares at prices other than those set by the fund and the fund's principal underwriter and disclosed in the prospectus. On the interbrand level, the SEC in its 1966 study of the fund industry concluded that the sort of competition generally prevailing was not price competition but competition among principal underwriters for the favor of retail dealers. The SEC further found that this form of competition "has not tended to reduce sales loads; on the contrary, it has raised the loads."[234] Additionally, just as lack of customer awareness seems to be the central reason for underdevelopment of price competition in the insurance industry, so also is the lack of investor knowledge cited as a prime reason for the stunted growth of interbrand price competition in the mutual fund industry.[235]

---

232. 15 U.S.C. § 80a-22(d) (1970). The statute reads, in relevant part:

> No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus.

For a detailed discussion of section 22(d) from its enactment through 1959, see Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 U. DET. L.J. 369 (1960). More recent analyses of the provision and its effect on mutual fund sales are presented in DISTRIBUTION REPORT 44-83; SECTION 22(d) REPORT; Heffernan and Jorden, *Section 22(d) of the Investment Company Act of 1940 — Its Original Purpose and Present Function*, 1973 DUKE L.J. 975; Hodes, *Current Developments Under Section 22(d) of the Investment Company Act*, 13 B.C. IND. & COMM. L. REV. 1061 (1973); Hodes, *Retail Price Maintenance: Section 22(d)*, in MUTUAL FUNDS, *supra* note 227, at 439; Simpson & Hodes, *The Continuing Controversy Surrounding the Uniform Price Maintenance Provisions of the Investment Company Act of 1940*, 44 NOTRE DAME LAWYER 718 (1969).

233. *Mutual Funds Conference*, *supra* note 196, at 787 (remarks of Professor Morgan Shipman).

234. PUBLIC POLICY REPORT 21. *See also The Mutual Fund Industry: Challenge or Crisis?*, FUNDSCOPE, Nov. 1972, at 11, 46.

235. *See* SECTION 22(d) REPORT, pt. 1, at A-91, A-106; *id.*, pt. 2, at 284; Statement of NASD, Inc., Feb. 2, 1973, at 20, SEC File No. 4-164.

However, the parallel between the insurance and mutual fund industries in the area of price competition is not exact in every respect. On the contrary, the spectacular rise in no-load sales — from 5 percent to 23 percent of the fund industry total in a decade[236] — shows a degree of price consciousness in the fund market that the individual life insurance market does not yet seem able to match. Further, in the mutual fund industry there is a pervasive federal presence not found in life insurance regulation. While it is still early in the new era of full and fair disclosure of salient facts by insurers, mutual funds can point to a marketplace policed for over 40 years by demanding disclosure requirements designed "to educate and clarify as well as present facts on which an investment judgment could be made."[237] The funds and their managements are also subject to the provisions of the Securities Exchange Act of 1934[238] and the highly complex regulatory patterns of the Investment Company Act of 1940.[239] Additionally, the funds must cope with state blue sky law regulation, including investor protection-oriented provisions in a number of states which have gone into areas left largely untouched in the insurance industry, including limits on front-end loads[240] and ex-

236. These calculations are based on data supplied by the No-Load Mutual Fund Association. No-load money market funds were not included. Had they been, the percentage of industry sales attributable to no-loads would have remained at 5 percent in 1964, but for 1974 the figure would have ballooned to 78 percent. In terms of total industry assets, the no-loads (excluding money market funds) experienced a growth from 1964-74 of from 4.5 percent of industry assets to over 12 percent. For further discussion of the gradual trend toward no-load marketing, see *Un-Loading?*, FORBES, Sept. 15, 1975, at 112.

237. *Hearings on the Powers, Duties and Functions of the Securities Exchange Commission Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 82d Cong., 2d Sess., pt. 1, at 57 (1952) (remarks of SEC Chairman Harry A. McDonald referring to the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.* (1970)).

238. 15 U.S.C. §§ 78a *et seq.* (1970).

239. 15 U.S.C. §§ 80a-1 *et seq.* (1970). Alluding to the complexity of the 1940 Act, former SEC Chairman Ray Garrett, Jr., once noted that: "It would have made things easier if it had been written in English." Garrett, *Mutual Funds: Fifty Years and Beyond*, in INVESTMENT COMPANY INSTITUTE, 1974 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 12, 13.

240. The sale of mutual funds by use of a contractual plan featuring a front-end load sales compensation arrangement is outlawed in California, Illinois and Wisconsin. *See* CAL. ADMIN. CODE tit. 10, § 260.140.80, in 1 CCH BLUE SKY L. REP. ¶ 8623, at 4547-2; ILL. REV. STAT. ch. 121 ½, § 137.7(D)(2) (Supp. 1975); WIS. AD. CODE ch. SEC 3.01(3) (1970). This treatment of the front-end load is in sharp contrast with the permissive attitude of the states toward front-end loading of commissions on whole life insurance contracts. *Cf.* note 56 *supra* and accompanying text. Another tack taken to protect shareholders from losses due to the front-end load for contractual plans has been to provide a 30-day free-look period. *See* [1950] Mass. Stat. ch. 822, § 3 (repealed 1972). Perhaps one considera-

pense levels.[241]

Perhaps the most fundamental difference between the competitive positions of the insurance and mutual fund industries lies in the manner in which outside forces have affected them. Critical analysis of, and public outcry over, perceived marketing deficiencies in the life insurance industry is a relatively new phenomenon. It was not until the latter half of 1975 that Senator Hart's bill was introduced and the Model Regulation was adopted by the NAIC. By contrast, the mutual fund industry has been studied, criticized, litigated against, and force-fed legislative and regulatory cure-alls to a fare-thee-well. In the words of former SEC Chairman Ray Garrett: "No issuer of securities is subject to more detailed regulation than mutual funds."[242]

A very large amount of the attention visited on the mutual fund industry has concerned the efficacy and coverage of section 22(d), which is the mainspring of the marketing system used by the load fund segment of the fund industry. Given that section 22(d) helps support the marketing system employed by the load fund segment of the mutual fund industry (which accounts for approximately 85 percent of the industry's assets), and given that the fund industry historically has enjoyed impressive sales success,[243] the necessity for debating the section's value is questionable. It appears at bottom that the reason for a controversy over section 22(d) is that the section is a "retail price maintenance" provision.[244] As such, its existence means that pricing in the fund

tion in the decision to repeal the Massachusetts free-look provision was the adoption in 1970 of a mandatory free-look privilege where a front-end load is assessed in a mutual fund sale. *See* note 186 *supra* and accompanying text.

241. *See generally* Baron & Ellis, *Mutual Fund Expense Limits*, 4 REV. OF SEC REG. 881 (1971).

242. Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at v.

243. In the thirty years after the passage of the 1940 Act, fund industry assets grew from $500 million to over $36 billion, with shareholder accounts rising from less than 300,000 to over 10,000,000. INVESTMENT COMPANY INSTITUTE, 1975 MUTUAL FUND FACT BOOK 7. While a good amount of the appreciation of fund assets can be ascribed to increases in the value of portfolio securities, the SEC's 1966 mutual fund report found that fund sales accounted for the lion's share of the increase in fund assets since 1940. PUBLIC POLICY REPORT 202.

244. The designation applies loosely, as explained by former SEC Chairman Garrett:

> The term "retail price maintenance" has been generally used . . . to describe the pricing practices required by Section 22(d). However, this type of pricing is different from retail price maintenance for consumer and other goods. The price of mutual fund shares has two components: the net asset value which fluctuates

industry runs counter to the normal presumption of prices set by free competition that operates in other segments of our economy;[245] additionally, the proclivity of retail price maintenance to raise prices to the consumer has been well demonstrated.[246] Critics of section 22(d) argue for repeal on the grounds that it: results in imperfect competition, with inefficient firms being overcompensated;[247] causes a customer who is already predisposed to purchase a load fund's shares to pay for selling efforts that "he does not want, does not need, and does not get";[248] hinders development of a secondary market in mutual fund shares;[249] and, in sum, makes prices generally higher than they would be under a competitive regime.[250]

> depending on the value of the fund's portfolio and, in many cases, a sales charge. Sales of shares at less than net asset value would result in dilution of the assets of the fund, and would clearly be detrimental to the interests of existing shareholders. Therefore the only aspect of the practice required by Section 22(d) which bears any resemblance to retail price maintenance for consumer goods is the requirement that the sales charges specified in the prospectus be binding on all dealers.

Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at i.

245. *See* MUTUAL FUNDS, *supra* note 227, at 458 (remarks of Professor Robert H. Mundheim); SEC Investment Company Act Release No. 7475 (Nov. 3, 1972); Statement of Merrill Lynch, Pierce, Fenner & Smith, Inc., Jan. 29, 1973, SEC File No. 4-164.

246. *See* Distribution Hearings Transcript 2063-64 (testimony of Barry Grossman of the Department of Justice mentioning a 1956 Department of Justice study showing prices to be 19 percent higher on the average in areas where retail price maintenance is in effect); Hollander, *United States of America*, in RETAIL PRICE MAINTENANCE 65, 97-98 (B. Yamey ed. 1966); Scanlon, *Oligopoly and "Deceptive" Advertising: The Cereal Industry Affair*, 3 ANTITRUST L. & ECON. REV. 99, 103-04 (1970).

247. *See* Testimony of Paul Samuelson, *supra* note 33. A reciprocal effect is that an efficient retailer

> who seeks to expand the volume of his business in the traditional free enterprise way of selling particular fund shares with a sales charge lower than that fixed by the underwriter cannot do so.

SECTION 22(d) REPORT, pt. 2, at 370.

248. PUBLIC POLICY REPORT 221. The SEC staff still adheres to this position. *Cf.* DISTRIBUTION REPORT 49 (pointing out that a sophisticated repeat investor is required by section 22(d) to "pay the full sales load to cover a selling effort which, presumably, he no longer wants, needs or gets").

249. *E.g.*, Comments of the United States Dep't of Justice, *supra* note 39, at 11-12. The hindrance arises because dealers are prevented from obtaining fund shares that are already outstanding in order to sell them to customers at prices lower than the fund's public offering price. The development of a secondary market in fund shares is discussed at text accompanying notes 351-68 *infra*.

250. SECTION 22(d) REPORT, pt. 2, at 372. The SEC staff found that cost savings as a result of repeal of section 22(d) would accrue mainly to small investors, although very small investors (those investing less than $1,000) probably would not receive any price benefit by reason of repeal. *Id.* at 374.

B. *The SEC's "More Competitive Environment" Program*

1. Background

In evaluating the Commission's present approach to section 22(d), it is useful to have some background knowledge of previous SEC attempts to grapple with retail price maintenance in the fund industry. In its 1966 report entitled *Public Policy Implications of Investment Company Growth*, the SEC gave much attention to mutual fund distribution in general, and section 22(d) in particular.[251] Even though the study convinced the Commission that fund sales charges should be lowered, it nevertheless refused to recommend abolition of section 22(d).[252] Observing that repeal

---

It deserves mention that the Justice Department, the leading advocate of repeal of section 22(d), has advanced two further "undesirable effects" said to accrue as a result of retail price maintenance in the securities industry. First, citing to author "Adam Smith's" account in *Supermoney* of the demise of certain go-go funds, the argument is made that "[t]he absence of vigorous price-competition in sales loads has directed rivalry . . . to short term fund performance, ignoring possible detriment to fund shareholders from such action." Comments of the United States Dep't of Justice, *supra* note 39, at 8. It might be more accurate to view the go-go phenomenon as an example of horrendous marketing judgment rather than an outgrowth of retail price maintenance. After all, two of the four mutual funds singled out in the passage cited by the Justice Department were no-load funds. *See* "ADAM SMITH," SUPERMONEY 94-95 (1972). The second "undesirable effect" mentioned by the Justice Department is a repetition of the observation in the *Public Policy Report* that to the extent the commission charge on fund shares is higher than for alternative forms of investment securities, salespersons may be led to recommend fund shares where a less remunerative product may be more suitable for their clients. *Compare* Comments of United States Dep't of Justice, *supra* note 39, at 9-10 *with* PUBLIC POLICY REPORT 221-22. The statement is not inaccurate, but it by no means describes a novel situation. Every salesperson who sells commodities in markets where competing alternatives pay different levels of compensation is automatically in a conflict of interest position. How well the customer fares in these cases will ultimately be determined by the salesperson's independence and sense of integrity.

Two additional arguments for eliminating section 22(d) advanced by another analyst of the investment company field are that: (1) the section is not needed to protect the financial well-being of retail dealers since most are large diversified firms; and (2) the section restricts the ability of retail dealers to be flexible in their competitive responses to insurers. Henderson, *Evaluating Possible Changes in 22(d)*, in MUTUAL FUNDS, *supra* note 227, at 451, 457. These points were, in Mr. Henderson's view, clearly subordinate to the central issue of whether sales loads were too high with section 22(d) in effect. *Id.* at 454-55.

251. PUBLIC POLICY REPORT 201-50. The *Public Policy Report* was preceded by two other studies that focused on issues related to mutual fund marketing. The first study was completed in 1962 by the University of Pennsylvania's School of Finance and Commerce. *See* WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, *supra* note 8. The other analysis was reported in the SEC's *Special Study of the Securities Markets* which made a number of recommendations concerning mutual fund marketing practices.

252. PUBLIC POLICY REPORT 222-23.

might have "unsettling and unforeseeable effects" on the broker-dealer community, the Commission recommended that the Investment Company Act be amended to limit the maximum sales charge to five percent.[253] Congress did not adopt the SEC's five percent ceiling, deciding instead to amend section 22(b) to allow rulemaking by the NASD with SEC supervision in order that mutual fund share prices "shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers and underwriters, and for reasonable sales loads to investors."[254]

The failure of Congress to act on section 22(d) was motivated in part by the belief of the Senate Committee on Banking, Housing and Urban Affairs that the consequences of repeal had been inadequately studied.[255] Accordingly, the SEC was asked to review the consequences of repeal on both the investing public and mutual fund marketing systems. In November of 1972 the Commission's staff delivered to the Commission an extensive report on the potential impact of repeal of 22(d), and in early 1973 the Commission convened hearings to explore issues related to repeal of section 22(d) and mutual fund distribution in general.[256] More

---

253. *Id.* at 223. Precisely where the five percent figure came from has been the subject of some speculation. *E.g.*, "There were five commissioners, so it came out five percent. It is interesting, too, that each Commissioner had five letters in his name at that time." MUTUAL FUNDS, *supra* note 227, at 405 (remarks of John A. Dudley). According to SEC Commissioner (then General Counsel) Philip A. Loomis, the five percent figure

> was based on a comparison with the sales compensation prevailing elsewhere in the securities markets, with a judgment that the sales load for mutual funds should be higher than prevails elsewhere, substantially higher, but not way, way out of line.

Mutual Funds Conference, supra note 196, at 800. *But see 1969 House Hearings* at 182 (1969) (SEC Chairman Hamer Budge testifying that the NASD five percent mark-up policy was the source of the figure).

254. Investment Company Act of 1940 § 22(b)(1), *as amended*, 15 U.S.C. § 80a-22(b)(1) (1970). The Senate Committee Report stated that the reasonable compensation requirement was designed

> [t]o assure that fair consideration is given to the interests of both sellers and investors. . . . This does not mean that such rules must preserve the current level of profitability of every salesman, broker-dealer, or underwriter in the business irrespective of efficiency. It does mean, however, that consideration must be given to the nature and quantity of services necessary to effect the proper distribution of fund shares to the public.

S. REP. No. 91-184, 91st Cong., 1st Sess. 8 (1969).

255. S. REP. No. 91-184, *supra* note 254.

256. SEC Investment Company Act Release No. 7475 (Nov. 3, 1972) announced the hearings and outlined the matters to be covered:

than 70 persons testified at the hearings and over 100 written comments were filed with the Commission.[257]

At the time the Commission's staff was making its study of the impact of abolition of section 22(d), the NASD, pursuant to its rulemaking power under section 22(b) of the 1940 Act, retained consultants to conduct an economic study of the distribution of mutual funds and variable annuities. The NASD's study concluded that the existing mutual fund sales load structure produced generally reasonable load levels when evaluated in terms of four standards: effective competition, value of service, sales force compensation, and costs of distribution.[258] Two months after

---

A. Repeal of Section 22(d) of the Act
   1. Complete repeal
   2. Partial repeal
   3. Price competition within a limited range
   4. A current public offering price described in the prospectus
   5. Prohibiting price competition from non-contract dealers

B. Rules under Section 22(b) and other Provisions of the Act
   1. Lower breakpoints reflecting the reduced cost of diversification on larger purchases.
   2. Regulation of the dealer discount
   3. Continuous discounts
   4. The value of additional product features
   5. Contractual plans

C. Further liberalization of advertising rules
   1. Advertising
   2. Statement of Policy

D. Simplified, more readable mutual fund prospectuses

E. Group sales

F. Reducing paperwork in small transactions

G. No-load sales

H. Development of an adequate economic data base

257. Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at iii.

258. The study defined effective competition as present "where the market mechanism, through price and product competition, protects the consumer from paying a price higher than necessary to provide a supply of acceptable quality." 1 NASD STUDY II-1. Unhappily, the difference between "acceptable" and "unacceptable" quality is not spelled out, nor is a yardstick furnished to gauge when prices become "higher than necessary." The value of service standard is likewise ambiguous. It supposedly is derived from analysis of the alternative opportunity costs of providing diversification of risk, various product features (including dividend reinvestment options and exchange privileges), and personal counseling. *Id.* at II-6 to -8. Thus the value of service standard does not appear to depend on "service" alone, but rather seems to be an amalgam of service and product

the study was published the NASD submitted to the SEC a proposed schedule of commission rates to be promulgated under section 22(b)(1).[259] In brief, the NASD proposal consisted of a set of maximum sales load levels plus a set of penalties by way of load reductions to be assessed against funds that did not provide certain privileges to their shareholders.[260] The SEC's acceptance of

values. For example, it is not easy to understand why diversification should count in consideration of the value of service standard for the purpose of evaluating the reasonableness of sales load levels, because diversification can be purchased at no sales charge through investment in a no-load fund. This mixing of product and service features casts doubt on the credibility of the value of service standard. Application of the third standard, sales force compensation, was said to indicate that the relatively high rate of compensation used to reward mutual fund sales persons was justified on the ground that the sales effort in hours per transaction for fund sales was greater than for other types of revenue producing transactions. *Id.* at III-64. This conclusion was supported by testimony at the mutual fund distribution hearings from Robert Cleary, a vice president of Merrill Lynch:

> Of all our 29 products, I would like to add one of the very few tings [*sic*] that all Merrill Lynch people agree with, and I assure you there are precious few, they all agree a mutual fund is the toughest product we have to sell.

Distribution Hearings Transcript 260. The final consideration, costs of distribution, was introduced with the disclaimer that "less weight should be given to the compensation standards than to other standards because of the difficulties of estimating an economically valid industry-wide cost." 2 NASD STUDY III-69. The study proceeded to find that the distribution of funds "is characterized by a wide dispersion of costs among firms" and "by a squeeze in profit margins." *Id.* at III-83.

259. *See* NASD Release No. 11,172 (Nov. 8, 1972), in [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,077, at 82,329.

260. The NASD proposal allowed maximum sales loads of:
8.50% for purchases of up to $10,000 or $15,000;
7.75% for purchases between $10,000 and $25,000; or
7.50% for purchases between $15,000 and $25,000; and
6.25% for purchases of $25,000 and over.

However, the right to charge that maximum was made contingent upon the offering of:

> (1) *Dividend reinvestment at net asset value.* If the fund elects to charge for dividend reimbursement, the maximum load it could charge would be reduced by 1.25 percentage points.
> (2) *Rights of accumulation.* (The right to purchase additional shares at breakpoints when the cost or the value of an investor's holdings plus any additional purchases reach the breakpoint level.) If a fund should choose not to offer a right of accumulation, the maximum load would be reduced by .5 percentage points.
> (3) *Volume discounts.* Failure to provide discounts at either the $10,000 or $15,000 purchase level and at the $25,000 purchase level could reduce the otherwise allowable sales load by as much as .75 percentage points.

The reason for the penalty provisions seems to be founded on the *NASD Study*'s conclusion that it may be necessary to "prod the laggards" in order for regulation to produce a price structure similar to that which would be set by competition. *See* 2 NASD STUDY II-4. But how is the regulator to judge whom to prod or how much? These judgments, which are central to the mandate of section 22(b)(1) that loads be fair to dealers

the NASD's proposal is discussed below in conjunction with a description of the SEC's price competition findings and recommendations.

2. Acceptance of the NASD's Proposal

The SEC's distribution hearings elicited comment on sundry facets of the mutual fund distribution system, including the issue of whether section 22(d) had outlived its usefulness. Numerous arguments were presented in favor of retention of the status quo. Among the arguments advanced in defense of section 22(d) were that: the "normal presumption" favoring competition is really not very normal in the securities industry where mutual funds compete with numerous products sold under fixed price regimes;[261] profits from distribution are not excessive;[262] cutbacks in compensation will: (1) lead to less time being spent with prospects which will hamper sales force efforts to do a professional job in assuring investment suitability, and (2) force retailers to turn to more remunerative but perhaps less suitable investment prod-

---

and customers, can best be made by the forces of competition in the marketplace, not by a bureaucracy. *See Mutual Funds Conference, supra* note 196, at 798-99 (remarks of Gordon Henderson).

261. This argument was advanced numerous times in connection with the SEC's mutual fund distribution hearings. *E.g.*, Statement of Channing Co., Inc. & Channing Mgm't Corp., Feb. 9, 1973, at 6-7, SEC File No. 4-164; Statement of Investment Company Institute, Feb. 2, 1973, at 7-11, SEC File No. 4-164; Statement of Investors Diversified Services, Inc., Feb. 12, 1973, at 6, SEC File No. 4-164. The Commission's staff made a close study of compensation offered by the competing products and concluded that fund compensation structures were not substantially more generous than those offered by competing products. *See* DISTRIBUTION REPORT 23-29 & chart III. Speaking out against retention of section 22(d), the Justice Department dubbed the argument that section 22(d) should be preserved because fixed prices exist in other securities distribution areas as the "Alphonse and Gaston Syndrome." The Justice Department complained that those who argue for fixed price systems so long as competitors have them resemble "five Englishmen, each trying to get through the door last." Statement of Barry Grossman, Chief, Evaluation Section, U.S. Dep't of Justice, Mar. 21, 1973, at 7, SEC File No. 4-164.

262. *E.g.*, Statement of NASD, Inc., Feb. 2, 1973, at 4, SEC File No. 4-164; Statement of Union Service Corp., Feb. 2, 1973, at 3, 5-6, SEC File No. 4-164; *Mutual Funds Conference, supra* note 196, at 804 (remarks of Robert M. Loeffler). But it has been argued that whether or not people engaged in the distribution process make excessive profits has nothing to do with whether or not section 22(d) causes sales charges to be too high:

> [C]learly you can fix sales charges at different levels, and if you want to pay a twenty percent sales commission, you probably could sell a lot more. No one is going to be getting an exorbitant profit, but the economy might be a lot worse off as a result. The fact that there are not exorbitant profits is not really relevant to this issue.

Id. at 807 (remarks of Dr. Irwin Friend).

ucts;[263] abolition of the fixed price system would put dealers in an untenable position if they charged a high price for a sale without disclosing that a lower price was available elsewhere;[264] "poten-

263. With regard to the suitability problem, *see, e.g.*, Distribution Hearings Transcript 177-78, 182 (testimony of Robert L. Augenblick); Statement of Dreyfus Corp., Feb. 2, 1973, at 6-7, SEC File No. 4-164; Statement of Massachusetts Financial Services, Inc., Feb. 1, 1973, at 3, 4, SEC File No. 4-164; Statement of Raymond, James & Associates, Inc., Feb. 2, 1973, at 1, SEC File No. 4-164; Statement of Securities Industry Ass'n, Feb. 5, 1973, at 5, SEC File No. 4-164; Statement of Union Service, Corp., *supra* note 262, at 5. On the other hand, comment was received to the effect that the overall level of sales force professionalism in the fund industry is not high. *Cf.* DISTRIBUTION REPORT 39-40, note 35 *supra*.

One fund dealer explained at the distribution hearings that a cutback in compensation would result in abandonment of the mutual fund line by his sales force:

> [W]hat will we do? I hate to say this, but . . . we would go to the variable life which would give us 100 percent commission to sell a mutual fund.
>
> I would have a little trouble living with it . . . . I figured out for my salesmen all they would have to do is sell about one $100 a month program and they make $10,000, where now they would make $780 on that.
>
> Whether I could philosophically live with it, I am not going to get into. But obviously we would go to the variable life, the investing public would take, in my estimation, one of the largest beatings they have ever taken.
>
> . . . .
>
> *Question*: Would you be going in that direction anyway toward the variable life?
>
> *Answer*: No, I will not touch variable life unless I am forced out of the mutual fund busines [*sic*]. . . . [V]ariable life . . . is a last resort for the small investor and it is a bad, bad last resort. But it is a salvation for 50 salesmen, the only salvation they have.

Distribution Hearings Transcript 956-58 (testimony of Robert Roth); *accord, id.* at 211-52 (testimony of Carl Frischling). Along this same line, the chief author of the NASD's mutual fund study has stated that:

> [I]f I am correct in my prognostication of the impact of repeal on the level of sales efforts made, it should not be overlooked that the salesmen probably will not leave the securities industry but will simply shift their efforts to other more profitable lines of endeavor. The experience of the past two years suggests that the investors' lot is not improved when the salesmen shift their efforts. The shift to closed-end funds, for example, which are not redeemable . . . and the majority of which typically sell at discounts from net asset value, have caused the investors substantial losses.

Sherwin Address, *supra* note 30, at 23.

264. *See* note 178 *supra* for one fund industry member's description of the dealer's dilemma. Also, see Distribution Hearings Transcript 894 (remarks of Raymond Cocchi). This two-price/professionalism issue came up in the course of testimony at the distribution hearings by a Justice Department official. The Justice Department witness at first declined to comment upon whether a broker-dealer owed a fiduciary duty to a potential purchaser to give him the best price for the security, but later opined that a salesman who spent five hours with a prospect had no duty to disclose that the shares were available elsewhere at a lower price. *Id.* at 2036-38 (testimony of Barry Grossman). It was further asserted that prospectus disclosure of the secondary market would be required. *Id.* at 2038-39 (testimony of Daniel Hunter).

tially disastrous" administrative problems would result if varying loads were charged;[265] "[p]rice competition in the mutual fund industry is rigorous, and has had the effect of lowering the effective level of sales charges unremittingly and year after year";[266] and, finally, repeal of section 22(d) could destroy the existing mutual fund distribution system and seriously weaken the fund industry by throwing it into a prolonged period of net redemptions.[267]

Lending credence to claims of chaos in fund distribution if section 22(d) was repealed were comments and testimony received by the SEC that

> made clear that the mutual fund industry is beset by new and serious difficulties quite different from the spectacular growth which the Commission reviewed in its 1966 Mutual Fund Report. Record sales of earlier years have given way to net redemptions; competing products have made substantial inroads; fund managers have diversified into other fields; many fund under-

---

Commentary concerning an insurance salesperson's possible duty to disclose price disparities to clients is presented in notes 190-207 *supra* and accompanying text. *See* note 197 *supra* and accompanying text for authority that casts doubt on the validity of the Justice Department officials' appraisal of the scope of a securities dealer's fiduciary duty. Furthermore, since testimony presented at the mutual fund distribution hearings indicated that prospectuses are seldom read by customers, it is questionable whether prospectus disclosure of lower prices would suffice to insulate a nondisclosing salesperson from liability. Distribution Hearings Transcript 926 (testimony of Ted Davis).

265. *See* Statement of Vance, Sanders & Co., Inc., Feb. 1, 1973, at 1-2, SEC File No. 4-164; Statement of Wellington Mgm't Co., Jan. 24, 1973, at 18-20, SEC File No. 4-164. The reason given is that an increasingly large number of fund orders are being placed by investors with fund transfer agents. Direct purchases (and dividend reinvestments and exchanges when they take place at other than net asset value) have a fixed offering price and it is claimed that they are too numerous to handle otherwise. Wellington Management Company mutual funds alone accounted for nearly 90,000 direct purchases in 1972. *Id.* at 19.

266. Statement of Wellington Mgm't Co., *supra* note 265, at 2. The statement cites statistics prepared for the use of NASD which reveal a 30 percent decline in the average level of mutual fund sales charges between 1960-70. The same argument is made in Statement of Union Service, Corp., *supra* note 262, at 3-4. The problem with the argument is, of course, that no one disputes that there *is* interbrand competition between funds for investors' favor — particularly between the no-load funds and the load funds. The place where there is no price competition is at the intrabrand level, which is where section 22(d) has its impact.

267. *E.g.*, Statement of Channing Co., Inc. & Channing Mgm't Corp., *supra* note 261, at 20-22; Statement of Professor Henry C. Wallich, Jan. 31, 1973, at 5, SEC File No. 4-164; Statement of Investment Company Institute, *supra* note 261, at 11-14. For additional comments, pro and con, concerning section 22(d) and its value to fund distribution and investors, see DISTRIBUTION REPORT 51-75.

> writers have allowed their relationships with small broker-dealers to deteriorate; and the industry has become increasingly dependent for sales upon large broker-dealers to whom mutual funds are a relatively unimportant source of income. Moreover, in many cases retailers fail to provide adequate service to fund shareholders after the initial sale.[268]

The SEC decided against recommending repeal of section 22(d). Viewing the industry as one that had been inhibited by "the present regulatory system" from capitalizing on a "demand pull" generated by such devices as advertising and price discounts, the SEC elected not to take precipitous action that could severely cut back "sales push" delivered by commissioned sales personnel. The main thrust of the SEC's fund distribution program involves use of its existing regulatory authority to lessen restrictions on fund marketing efforts in order to create a "more competitive environment." To back up its decision to allow the industry to move "voluntarily" in the direction of price reductions, the SEC announced its intention to ask Congress to vest the Commission with authority to take various additional actions, including power to prohibit retail price maintenance.[269]

Faced with the problem of what to do about load levels while its comprehensive program was being implemented, the SEC elected to accept the NASD's proposed maximum sales load rule with some minor modifications.[270] The chief reasons given for the willingness to accept the NASD's proposals were a reluctance to bridle the industry with further restraints on compensation at a time when its marketing mechanism was disrupted together with the inability of the Commission's staff to produce data that would

268. Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at iii-iv. A detailed discussion of the marketing position of the fund industry at the time it was studied by the staff is presented in DISTRIBUTION REPORT 17-43.

269. The Commission's program is digested in Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at vi-vii. The program is spelled out in detail in DISTRIBUTION REPORT 84-135.

270. *See* DISTRIBUTION REPORT 125-31. The modifications recommended by the staff involved a requirement that a penalty be assessed against funds that fail to offer an exchange privilege and a special set of low sales loads for cash management funds. *Id.* at 129-31. The NASD's rule change was ultimately approved by the SEC in the fall of 1975. *See* SEC Securities Exchange Act Release No. 8980 (Oct. 10, 1975). In that release the Commission noted its "understanding" that the NASD would "continue to consider the need" for attention to the exchange privilege and cash management fund questions raised by the staff.

undercut the conclusions reached in the NASD study.[271] The NASD's maximum loads were thus viewed as a useful intermediate step down the path to lower loads.

The key components of the Commission's "more competitive environment" program are reviewed below. The discussion details and analyzes the SEC's action to: (1) allow mutual funds to communicate more effectively with investors through advertising; (2) introduce more price variation in the load fund sales load structure by allowing expanded use of group sales, sales to fund shareholders at cut-rate prices, and discounts on fund shares when sold in combination with another investment product or an insurance product; and (3) permit greater price flexibility in brokered transactions through development of a brokered secondary market.[272] The NASD study considers the extent to which the Commission's efforts seem necessary and capable of achieving the desired replacement of "sales push" with "demand pull."[273]

3. Encouraging Voluntary Price Competition

a. *Easing Advertising Restrictions*

(1) *The Utility of Advertising.* It has been said that

---

271. *See* DISTRIBUTION REPORT 125-27. This does not mean that the NASD's analysis is beyond criticism. *See* note 258 *supra*. According to testimony presented at the hearings, adoption of the NASD's rule would mean that: (1) two-thirds of all load mutual funds would have to make some downward adjustment in their load structure; (2) 24 percent of funds would have to lower sales charges at the breakpoints; (3) 22 percent of the funds would have to start providing dividend reinvestment at net asset value; and (4) 38 percent would have to begin making rights of accumulation available. Distribution Hearings Transcript 26 (testimony of John Bogle).

272. Other aspects of the SEC's program deserve mention. The SEC's efforts to allow a more accurate portrayal of fund performance in sales literature is discussed at note 304 *infra* and accompanying text. The Commission also announced as part of its program that it was authorizing the staff to view favorably requests by brokers (which act independently of funds and principal underwriters) for permission to charge fees in connection with the sale of no-load shares. *Cf.* note 277 *infra*. Another part of the SEC's mutual fund program involved exemption of variable annuities from section 22(d). *Cf.* note 74 *supra*. The action hardly represented a major break-through. In the *Distribution Report* the staff noted that 45 exemptions from section 22(d) were given to variable annuities between July 1969 and September 1973. DISTRIBUTION REPORT 103 n.1.

273. The strength of the SEC's commitment to a gradual erosion of sales push marketing in the fund industry is indicated by a footnote in the staff report on fund distribution that declares that, even if the Commission is vested with authority to prohibit retail price maintenance in the sale of fund shares,

> the Commission would not require - or even permit - retail price competition until it became clear that the necessity for a sales "push" had been largely replaced by a demand "pull."

DISTRIBUTION REPORT 119 n.1.

"[e]very company is cast, by the very nature of customers and competition, into the role of communicator."[274] In their effort to reach and persuade target markets, communicators employ a number of promotional approaches: personal selling; routine paid nonpersonal selling (advertising); non-paid, nonpersonal selling (publicity); and demonstrations, exhibitions or special deals for customers or retailers (sales promotion).[275] Although each of these ingredients of the promotion mix plays a role in the field of mutual fund marketing,[276] the advertising and personal selling

---

274. P. KOTLER, *supra* note 2, at 623.

275. *Id.* at 647-52.

276. The development of publicity efforts to generate customer interest seems to have been concentrated primarily in the no-load segment of the mutual fund industry. *E.g.*, Schaeffer, *No-Load Sales: Maintaining Momentum*, MUTUAL FUNDS FORUM, Feb. 1972, at 5, 6 (observing that the T. Rowe Price group has "had some success in cultivating the friendship of the financial writers around the country and getting items written concerning our funds that were unsolicited"). Sponsors of certain no-load mutual funds consider favorable publicity such a useful marketing tool that they have hired a public relations firm to promote helpful commentary about no-load investment. *See* Distribution Hearings Transcript 485-87 (testimony of Daniel Samuel).

Sales promotion is not unknown in the fund industry. *See* Debard, *CNA/ISI Marketing Mission - 1970*, INVESTMENT DEALER'S DIGEST, May 19, 1971, at 51; *1972 Forbes Mutual Fund Ratings*, FORBES, Aug. 15, 1972, at 73, 99. A form of sales promotion once used by many mutual funds to generate sales involves the direction of mutual fund portfolio brokerage commissions to fund dealers as a special incentive to favor a given fund's shares. This type of PM or "push money" trade promotion involved the use of two devices that are now outlawed. The first was the use of the customer-directed give-up by which a broker agreed to "give-up" to broker-dealers selected by his client a portion of the sales commission the broker was required to charge by reason of the NYSE's inflexible minimum commission rate structure. Give-ups have been abolished since December of 1968. *See generally The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 883-84 n.1012 (1969). The other type of brokerage commission PM used by mutual fund managements to generate sales was the practice of placing fund brokerage business with favored broker-dealers to reward them for selling fund shares. *See generally Mutual Funds Conference*, *supra* note 196, at 823-54.

In its 1972 *Statement on the Future Structure of the Securities Markets*, the Commission criticized the use of "sales recips" on five counts: (1) mutual fund retail dealers may be led to put their desire for compensation ahead of their clients' interest in a suitable investment; (2) the pressure to generate sales recips may lead to improvident investment decisions by management to the damage of shareholders; (3) interfund competition is adversely affected because small funds cannot generate the level of brokerage that may be allocated by larger funds; (4) to the extent that a portion of selling costs are imposed on fund shareholders, there may be a violation of "principles of fairness which are at least implicit in the Investment Company Act"; and (5) customers who purchase fund shares are deprived of their right to know what amount of sales compensation is involved in the transaction. SEC, STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS 18-19 (1972). Based on its observations of problems attendant to sales recips, the Commission resolved to request the NASD to formulate and implement rules to terminate the practice. *Id.* at 58. The NASD subsequently proposed a modification of its Rules of Fair Practice

components are today by far the most important. There is no doubt that personal selling is the primary means of promoting the sale of mutual funds in a very large segment of the market. But it is also self-evident that personal selling, standing alone, does not offer mutual fund marketers an efficient means of exploiting all target markets.

One market in which personal selling has little influence is that populated by sophisticated, self-motivated investors who are attracted to the no-load mutual funds.[277] Increased mutual fund

---

to ban sales recips. The SEC reviewed these modifications and did not disapprove. SEC Securities Exchange Act Release No. 10147 (May 14, 1973). The proposals became effective as to NASD members on July 15, 1973. CCH NASD MANUAL ¶ 2176, Rules of Fair Practice, art. III, § 26(k) (1975). The Commission later adopted a rule to ban receipt of sales recips by broker-dealers who are registered with the SEC under the 1934 Act and do not belong to the NASD. SEC Securities Exchange Act Release No. 10439 (Oct. 19, 1973).

Another sales promotion method that has been used in the marketing of certain financial services involves the offering of free gifts such as desk calendars, pocket pens, or road atlases in mass mailings distributed to prospects in order to generate leads. This free gift approach is a common feature of direct mail programs undertaken by large, broad line agency insurance companies to assist their agents. NASD, ANALYSIS OF ALTERNATIVE METHODS OF DISTRIBUTING MUTUAL FUNDS: DIRECT MAIL ADVERTISING PROGRAMS AND GROUP SALES III-32 (1972). The use of free gifts by mutual funds as a consumer sales promotion is reportedly not permitted by the SEC on the ground that the offer of a free gift constitutes a discount from the offering price in violation of section 22(d). *Id.* at II-6 to -7.

277. There are, however, a number of ways in which personal selling has assisted no-load distribution. For one thing, the no-loads have frequently benefitted by being able to sell to customers who were taught about mutual funds by load fund salespersons. *See* Distribution Hearings Transcript 422 (testimony of Daniel Samuel). Another way the no-loads have benefitted from a sort of personal selling is through being recommended to prospects by their shareholders. According to Mr. Charles W. Shaeffer:

> To date we have found that once an investor has selected one of our funds on his own and has enjoyed some investment success, he naturally has "pride of authorship" and is very generous in spreading our name among his friends.

Distribution Hearings Transcript 502-03. *See also id.* at 420 (testimony of Daniel Samuel). In some cases, sales have been spurred by payment of fund brokerage commissions to selling broker-dealers. *Cf.* Fogel v. Chestnutt, 2 CCH MUTUAL FUNDS GUIDE ¶ 10,246, at 13,401 (2d Cir. 1975). Indeed, one securities salesman has reported that he was offered a position with a securities dealer who promised greater compensation for selling a no-load fund than could be obtained on load fund sales. *See* Letter from George E. Shepherd to William J. Casey, Dec. 1972, in SEC File No. 4-164. The no-load was One William Street Fund. *See* Letter from George E. Shephard to John P. Freeman, Mar. 28, 1973, copy on file with the *South Carolina Law Review*.

As part of its more competitive environment program, the Commission announced its intention to allow brokers to start charging loads on no-load sales. The purpose of the action was to "provide brokers with an incentive to recommend no-load fund shares somewhat comparable to that existing with respect to other securities." In SEC Staff Letter to Parker/Hunter Inc. Dec. 30, 1975, *reprinted in* 2 CCH MUTUAL FUNDS GUIDE ¶ 10,190, the staff interpreted the Commission's action as providing only for charging "ministerial expenses." The letter set forth a list of "safeguards" to be complied with where

advertising offers particular benefits to the no-load proprietor since increased public understanding about fund investment will mean greater appreciation by investors of the cost savings afforded by no-loads. Advertising has a second marketing plus over personal selling in the area of product differentiation or "brand image" creation. With hundreds of mutual funds in operation, an effort by a management to give its company a distinctive personality makes good business sense for at least two reasons. First, the creation of a favorable brand image by a company for itself and its products is responsive to the instinctive desire of many customers to have a feeling of confidence in the things they buy.[278] Second, apart from generating consumer confidence and acceptance, development of a favorable image can transform a company's offering from a product that a dealer may or may not choose to carry into a brand name good that virtually must be stocked.

Another task that can perhaps be accomplished better by advertising is the dissemination to the public of objective data relevant to the purchase decision. In both the mutual fund and insurance industries, personal selling is the norm, and in each industry a perceived lack of price competition has been attributed to customers' failure to appreciate cost savings offered by alternative choices. Advertising holds the potential for exerting a downward pressure on prices by increasing customer awareness of cost differences among competing products.[279] An additional advantage offered by advertising in the sale of financial services is that it can improve the effectiveness of a sales presentation by

---

fees are charged in connection with no-load sales. In this context a commission charge of $20 per transaction for purchases of at least $5,000 in no-load shares has been approved by the staff subject to certain conditions. *See* SEC Staff No-Action Letter to Fahnestock & Co., Nov. 22, 1974, *reprinted in* 2 CCH MUTUAL FUNDS GUIDE ¶ 10,126.

278. *Cf.* note 31 *supra*. On the other hand, there always exists the possibility that the use of image advertising to spur sales of mutual funds will result in customers buying the brand name without having a solid grasp of the product's attributes. An executive for one of the leading brand image advertisers in the fund industry testified at the distribution hearings that:

> It has occurred time and time again . . . that you ask people if they are familiar with the name of Dreyfus . . . they say they are. And it sounds wonderful and you say well, do you know what a mutual fund is? And they don't.

Distribution Hearings Transcript 1181 (testimony of David Burke). For comments on the level of sophistication evidenced by shareholders redeeming their shares in Dreyfus Fund, see Rubens, note 36 *supra*.

279. *Cf.* note 175 *supra* and accompanying text.

educating customers about the rudiments of the products or services in question prior to the time they are contacted by sales personnel. It is obviously easier to explain to a prospect why *XYZ* Mutual Fund is the right choice if the prospect has been "pre-conditioned" by advertising and brings to the meeting an awareness of what a mutual fund is. Aside from being a means of economizing personal selling time and effort, pre-conditioning of the prospect by exposure to relevant information could tend to counteract or discourage overselling.

One final area where advertising can make a useful contribution in mutual fund marketing is in the field of post-purchase customer communication. In the mutual fund industry, as in the insurance industry, the rate of sales force turnover is high, and there are said to be many orphan accounts.[280] The inability of many salespersons to provide post-sale service has the effect of depriving numerous purchasers of a source of reassurance that could alleviate post-purchase anxiety. And it is recognized that advertising can have a valuable positive effect in reducing post-purchase anxiety.[281]

(2) *The SEC's Efforts to Make Advertising More Useful.* Because advertising obviously has much to offer to mutual fund marketing, it is surprising that the acceptance of informative advertising as an appropriate promotional tool in the sale of mutual funds is only a very recent development. In fact, it was not until nearly four decades after the passage of the 1933 Act that the SEC permitted mutual funds to do much more than recite their "name, rank and serial number" in so-called tombstone advertisements.[282] This suppression of advertising freedom is an

280. *See* notes 34 & 36 *supra* and accompanying text.

281. A discussion of cognitive dissonance is presented at notes 176-81 *supra* and accompanying text. There was some discussion of mutual fund investors' post-purchase anxiety at the distribution hearings. Mr. Bradley Baker testified that:

> Something that would be interesting I think to observe . . . in the covering of these closed-end funds it has been a particular problem for many of us that investors see these offerings in the papers and the bad publicity on open-end funds and all of a sudden want to cash in their open-end funds and buy one of these closed-end funds. And we have had in many instances to spend hours literally per day talking people out of making this switch which is not in their best interest in most cases.

Distribution Hearings Transcript 1061. For a discussion of the usefulness of advertising in quelling post-sale anxiety, see P. KOTLER, *supra* note 2, at 135. *See also* Hunt, *Post-Transaction Communications and Dissonance Reduction*, J. MARKETING, July 1970, at 46; Lawson, *supra* note 227, at 93.

282. The prospectus delivery requirement of the 1933 Act is set forth in section

outgrowth of the thoroughgoing information scheme contemplated by the prospectus requirements of the 1933 Act[283] whose purpose is to promote rational decisions in security dealings. However, experience has shown the Commission's limitations on the information that may be carried in fund advertisements may have had the rather perverse effect of encouraging the sale of equity products on the nonrational basis of impressions gleaned from brand image-type advertising.[284] In short, administrative

5(b)(1), 15 U.S.C. § 77e(b)(1) (1970). That section forbids the interstate transmission of a "prospectus" (defined in section 2(10) of the 1933 Act, 15 U.S.C. § 77b(10) (1970), to include a written or electronically broadcast advertisement which offers any security for sale) unless the prospectus satisfies the detailed requirements of section 10 of the Act, 15 U.S.C. § 77j (1970). While oral offers to sell are outside the purview of the prospectus requirement, such communications are subject to the antifraud provisions of sections 12(2) and 17(a) of the 1933 Act, 15 U.S.C. §§ 77*l*(2) and 77g(a) (1970), section 10(b) of the 1934 Act, and rule 10b-5 thereunder, 15 U.S.C. § 78j(b) (1970) and 17 C.F.R. § 240.10b-5 (1975), and, in the case of investment advisers who advise only investment companies, section 3(b) of the Investment Advisers Act, 15 U.S.C. § 80b-3(b) (1970). Apart from oral communications that are not electronically broadcast and written communications that are not offers for sale, the only other statements that may be made are tombstone advertisements pursuant to section 2(10)(b), 15 U.S.C. § 77b(10)(b) (1970).

It was rulemaking by the SEC pursuant to section 2(10) that resulted in the name, rank and serial number type disclosure that distinguished mutual fund advertising until recent liberalization. *See* SEC rule 134 (prior to amendment), 17 C.F.R. § 230.134 (1971) (listing different communications not deemed to be a prospectus); SEC Securities Act Release No. 4940 (Dec. 23, 1968) (discussing circumstances under which references to banking or insurance services may appear in investment company tombstone ads); SEC Securities Act Release No. 4709 (July 14, 1964) (listing various types of information that could not properly be included in a tombstone ad). For criticism of some SEC positions see McDougal, *Tombstone Territory and Beyond*, 21 ASS'N OF LIFE COUNSEL PROCEEDINGS 65 (1970). For general discussions of investment company advertising and the first phase of the SEC's effort to bring about more sensible limitations on advertising by investment companies, see Phillips, *Mutual Fund Advertising*, 5 REV. SEC. REG. 977 (1972); Romanski, *The Role of Advertising in the Mutual Fund Industry*, 13 B.C. IND. & COMM. L. REV. 959 (1972); Wagner, *Investment Company Advertising*, in PLI, THE SEC SPEAKS 33 (1972).

283. [T]he fact is that, legally, a mutual fund share is a security, and to say that it can be sold by means of advertising, while no other securities can, under a statute which draws no such distinction, is not too easy.

> There possibly could be special legislation for the mutual funds . . . . I think some case could be made for it. On the other hand, this would open up the whole question that was decided by Congress in 1933 and reaffirmed in 1954 — securities should be sold by supervised disclosure in a prospectus and by oral solicitations, but not by unsupervised advertisements.

Mutual Funds Conference, *supra* note 196, at 777 (remarks of SEC Commissioner (then General Counsel) Phillip A. Loomis).

284. Despite the 1933 Act's restrictions on advertising, a number of funds, particularly Dreyfus Fund and Oppenheimer Fund, have succeeded in cultivating brand images. *Cf.* Testimony of John D. Weller, *supra* note 31. For a discussion of how Dreyfus and Oppenheimer and some other funds have been allowed to make use of image-type advertising in the face of tight restrictions by the SEC, see Romanski, *supra* note 282, at 1007.

action (or inaction) prompted by a desire to promote a rational investment decision seems to have cultivated an advertising environment which resulted in people purchasing products they did not understand.[285]

Recognizing that sellers and purchasers are best served by a disclosure system that allows the maximum permissible flow of useful information, the SEC recently has made what one staff member termed a "valiant, sincere effort"[286] to increase the effectiveness of communication about mutual funds. Phase I of the SEC's efforts to liberalize restrictions on advertising was shown by promulgation of Securities Act Release No. 5248 in May of 1972.[287] In that release the SEC took what it called "a modest step" in the direction of more useful disclosure in the investment company area by: broadening the scope of permissible discussion in tombstone ads, encouraging the placement of generic advertisements of investment company securities, permitting use of visually attractive designs and devices in tombstone ads, allowing ads for investment company securities to be combined with ads for other products and services, and sanctioning the use of summary prospectuses by open-end companies.[288] The Commission

285. Through SEC Investment Company Act Release No. 7189 (May 25, 1972), the Commission moved to allow shareholders who redeemed their shares in a load mutual fund to reinvest their shares within 15 days with no sales charge penalty. The Commission noted that in cases where an investor chooses to reinvest it is possible that the original decision to redeem "resulted from a misunderstanding as to his rights or as to the characteristics of the security." Dreyfus Corp., one of the leading proponents of brand image advertising, was one of the first organizations to request the SEC to allow reinvestment at net asset value by redeeming shareholders. *See* FORBES, Aug. 15, 1972, at 99. Dreyfus' request was prompted by a survey of redeeming shareholders that showed "an appalling ignorance of their rights as fund-holders and the options open to them." *Id.*

286. Distribution Hearings Transcript 1258 (remarks of Alan Rosenblat).

287. SEC Securities Act Release No. 5248 (May 9, 1972).

288. The liberalization of tombstone advertising was achieved by amendment of rule 134, 17 C.F.R. § 230.134 (1975). The Commission amended subparagraph (c) of rule 134(a)(3), 17 C.F.R. § 230.134(a)(3)(c) (1975), to permit a general description of what an investment company is, including its general attributes, method of operation and the services offered, provided the description is not inconsistent with the operation of the investment company mentioned by name in the prospectus.

The May release also announced the adoption of new rule 135a, 17 C.F.R. § 230.135a (1975). Rule 135a was drafted specifically to encourage placement of generic advertising for mutual fund shares, including, for the first time, placement of ads by dealers who serve as underwriters or sponsors of investment company shares. Dealers who served as underwriters or sponsors of investment company shares previously had been banned from doing any generic advertising on the ground that such a dealer is presumed to desire to sell the security it underwrites or sponsors, and thus the generic advertising would constitute a prospectus. *See* Phillips, *supra* note 282, at 979; Romanski, *supra* note 282, at 1011. At

did not recommend any change in the statutory requirement that the use of sales literature be preceded or accompanied by a full statutory prospectus, however.

Phase II of the Commission's effort to bring about more reasonable limits on the advertising of investment company shares began immediately upon promulgation of the May release which contained a request for further proposals for liberalizing advertising restrictions. This call for industry input was reiterated in November of 1972 in the Commission's release announcing the commencement of hearings on mutual fund distribution.[289] In its autumn release the Commission announced that among the areas to be probed at the hearings were liberalization of advertising, and reassessment of the Commission's Statement of Policy[290] governing the content of investment company sales literature. The release also noted that the Commission had enlisted the support of a special advisory committee to deal with prospectus disclosure issues and related subjects.[291]

To focus comment at the distribution hearings, in January

---

the distribution hearings an executive for Merrill Lynch explained that his firm had sponsored generic advertising for mutual funds. The result was called "a statesman-like disaster. . . . We had no response to it at all except from the mutual fund industry who thought it was terrific." Distribution Hearings Transcript 293 (testimony of Robert Cleary).

The Commission's decision in the May release to allow pleasant designs in ads, including moving logos in televised tombstones, marked the culmination of a gradual move toward liberality (and sensibility) in judging logos and illustrations. *See* Romanski, *supra* note 282, at 1006-07 & n.251. The decision to permit combination ads was achieved through addition of paragraph (a)(13) to rule 134, 17 C.F.R. § 230.134(a)(13) (1975). The Commission's addition of the new paragraph affirms the stance it took in SEC v. American General Life Ins. Co., [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,905 (S.D.N.Y. 1970). In that case the SEC took the position that even the mere intermingling in an advertisement of an investment company's name with the names of other service companies controlled by a financial conglomerate turned the ad into a prospectus that did not meet the requirements of section 10, and thus violated section 5(b) of the 1933 Act. The change allowing use of summary prospectuses was accomplished by amendment to rule 434a, 17 C.F.R. § 230.434a (1975).

289. SEC Investment Company Act Release No. 7475 (Nov. 3, 1972).

290. 22 Fed. Reg. 8977 (1957). The descriptive Statement of Policy was issued by the Commission "so that issuers, underwriters and dealers might understand certain of the types of advertising and sales literature which the Commission considers may be violative of the statutory standards." *Id.*

291. On December 26, 1972, the advisory committee submitted to SEC Chairman Casey its recommendations for improving disclosure and reducing paperwork in the investment company area. *See* SEC Advisory Comm. on Investment Companies and Advisers, Recommendations to Improve Reporting and Reduce Paperwork for Investment Companies and Investment Advisers (1972).

of 1973 the Commission issued a release that put forward new proposals designed to improve the quality of information available to prospective investment company shareholders.[292] In that release the Commission took the position that investment companies are sufficiently different from other issuers to warrant customized disclosure treatment. With respect to tombstone advertising, the Commission proposed an easing of restrictions to permit investment companies to discuss their own features and services.[293] Two significant limitations remained, however. First, use of performance figures continued to be banned (on the ground that their disclosure would convert an ad into an offer to sell), and secondly, disclosure of various bits of information (such as the company's objectives and policies and method of operation, net asset value at a recent date, and logos) would be allowed only if disclosure also was made of advisory and administrative fees, and loads and redemption charges.

During the distribution hearings, some interesting comments were made about the utility of advertising in mutual fund marketing. In particular it was noted that: there is no data supporting the cost-effectiveness of load mutual fund advertising;[294] "the economic resources of the industry are such that advertising must remain a tool of limited usefulness";[295] advertising has signifi-

292. SEC Securities Act Release No. 5357 (Jan. 17, 1973).

293. Included among the data that could be disclosed under the release were: disclosure of a company's objectives and policies; services and methods of operation; key personnel of the company and its adviser; the company's date of incorporation; and its total net asset value. These changes were to be accomplished by amendment to rule 134. The January 1973 release also proposed adoption of a new rule 425b which would require each prospectus mailed in response to a coupon request to have a legend on the front page admonishing the recipient to read the prospectus carefully before investing.

294. *E.g.*, Statement of NASD, Inc., *supra* note 262, at 56.

295. Statement of the Investment Company Institute, *supra* note 261, at 69. It was stated that the quoted language was "one important point upon which all agree." *Id.* One mutual fund industry executive has explained the situation as follows:

> It needs no extensive analysis of advertising costs and management fee revenues to reach the obvious conclusion that media costs alone, whether print or television, preclude any meaningful advertising program for the mutual fund industry.
>
> For example, a 30-second spot in prime network television time can run as high as $100,000. . . . In 1973, the Investment Company Institute, on behalf of the entire industry, spent over $1 million on a very modest television advertising campaign which involved about sixty 30-second prime time exposures of a single commercial in an entire year. During SEC hearings on mutual fund distribution conducted in 1973, one witness pointed out that in the year 1971, Allstate Insurance Company spent about $8 million, Prudential about $7 million, and Metro-

cance only for large complexes or "financial conglomerates";[296] most "larger investors" already know what mutual funds are, even if many individuals do not;[297] many load fund dealers are using "dealer only" material as sales literature;[298] virtually no one reads mutual fund prospectuses;[299] and the basic selling tool of the mutual fund industry is performance.[300]

Following consideration of these and other comments on the utility of advertising in mutual fund distribution, the Commission adopted measures further liberalizing restrictions on advertising of investment company shares in November 1974.[301] The SEC's action generally consisted of adoption of the proposal made nearly two years earlier. The scope of disclosure suggested by the proposal was narrowed in only one respect,[302] while the requirement of fee and sales load disclosure was dropped.[303] The

---

politan Life about $5 million on advertising. A typical $1 billion mutual fund will not even produce gross advisory fee revenues for its sponsor in the amounts expended by any of these three companies for advertising purposes alone. Under existing ground rules, it is apparent that the mutual fund industry cannot consider advertising as having a meaningful role in the mass distribution of fund shares.

Haire, *A Call for Action on Fund Advertising Rules*, MUTUAL FUNDS FORUM, Dec. 1975, at 1, 11-12.

296. *E.g.*, Distribution Hearings Transcript 381 (testimony of Ralph P. Coleman, Jr.); Statement of Massachusetts Financial Services, Inc. *supra* note 263, at 5.

297. Distribution Hearings Transcript 783 (testimony of Robert Perez); *cf. id.* at 870 (testimony of John D. Weller): "Today almost everybody knows what a mutual fund is . . . ." However, a 1971 study sponsored by the Investment Company Institute indicated that only three out of every ten households "know something" about mutual funds. *See* INVESTMENT COMPANY INSTITUTE, THE PUBLIC'S ATTITUDE TOWARD MUTUAL FUNDS 2 (1971). *See also* Distribution Hearings Transcript 872 (testimony of Frank Rozanski arguing that "9 out of 10 people do not know what a mutual fund is").

298. Distribution Hearings Transcript 470 (testimony of Daniel Samuel).

299. *Id.* at 926 (testimony of Ted Davis).

300. *Id.* at 519 (testimony of William Thompson); *id.* at 1156 (testimony of Manuel Glassman). In answer to the question: "What is to be done for the mutual fund industry?", Mr. Glassman stated, "Just one thing. If fund managers have better performance, then the public will have better confidence. It is as simple as that." *Id.*

301. SEC Securities Act Release No. 5536 (Nov. 4, 1974).

302. The provision permitting identification of fund directors and key personnel of the adviser was deleted, though provision was made for identification of the fund's "principal officers." *See* 17 C.F.R. § 230.134(a)(3)(iii) (1975). The reason for the cut-back in personnel who could be listed in ads was stated to be a concern that boards would be stocked with celebrities having no investment expertise. SEC Securities Act Release No. 5536 (Nov. 4, 1974).

303. However, the amendment did require that ads using coupons for ordinary prospectuses include a legend on the coupon making reference to fees, expenses and, in the case of load funds, sales charges. *See* rule 134(a)(iii)(G), 17 C.F.R. § 230.134(a)(iii)(G) (1975). Another instance of liberalization of the proposed rules requirements involved

Commission maintained its position that performance data has no place in mutual fund ads, though it did move in a separate release to propose an amendment to the SEC's Statement of Policy to provide for improved disclosure of performance in sales literature.[304] However, no changes in the Statement of Policy have yet been made. Following up on its November action, the Commission in June 1975 again acted to ease advertising restrictions, but the changes were mainly of a technical nature.[305]

(3) *Commentary*

(a) *Advertising of Performance.* The Commission's staff pointed out in its report on mutual fund distribution that "[a]dvertising can be an effective merchandising tool."[306] But this truism, like the SEC's advertising program to date, glosses over some of the hard questions that may be asked about the use of advertising by mutual funds. What sort of advertising appeals can be effective? For whom can advertising be a useful tool? Whose money may be used to pay for advertising? In terms of information that may be included in advertisements, it seems that if it is desirable to cultivate "[g]reater investor understanding and more meaningful comparisons of past investment returns, risks and costs and their effect on investment returns" as the Commission's staff has stated,[307] and if such performance-oriented disclosures are currently prohibited by the 1933 Act from appearing in ads, then the SEC should join hands with the mutual fund industry and ask Congress for amendment of the 1933 Act to allow such disclosures in advertisements. Why should mu-

---

rejection of the proposal to adopt new rule 425b, discussed in note 293 *supra*. The proposed new rule apparently was rejected on the ground that the prospectus cover already had enough legends on it.

304. Securities Act Release No. 5537 (Nov. 4, 1974). The Commission's proposal has been criticized on the ground that the performance disclosures are too complicated for most people to understand. Haire, *Challenge: The Changing SEC Rules on Distribution*, in INVESTMENT COMPANY INSTITUTE, 1975 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 31, 32.

305. *See* SEC Securities Act Release No. 5591 (June 16, 1975). The latest amendments to rule 134 were prompted in part by a desire to clarify type-size requirements for advertisements and to do away with unintended discrimination against certain investment companies. The Commission also broadened rule 134 to allow increased use of pictorial illustrations and a description of goals to which an investment in the company could be directed (not related to investment performance).

306. DISTRIBUTION REPORT 12.

307. *Id.* at 86.

tual funds be prevented by law from advertising their basic product —investment performance—while competing investment media are allowed to do so?[308] Simply put, if performance advertising is in the public interest, then mutual funds should be allowed to use it; if performance advertising is not in the public interest,[309] then the SEC should act to protect investors by prohibiting all professional money managers from using it.

(b) *The Value of Advertising to Load Funds.* Another interesting facet about the SEC's advertising program is that it does not seem to be very helpful to the group that the SEC's more competitive environment program is primarily designed to reach: the load funds. The SEC's advertising program is designed to make it easier to educate the public about fund investment. It is true that load fund marketers can benefit from informative advertising that pre-conditions prospects, thus making the job of sales personnel easier. But it is doubtful that the benefit to the load funds is as substantial as the SEC seems to believe.[310] Com-

---

308. The headline for one ad placed by The National City Bank of Cleveland asks: "Are your equity investments returning 10% a year? If not, read this." The ad goes on to state, "National City Bank has delivered 10.2% annual compound rate of return on equities over the past five years." Another ad, run by First Pennsylvania Bank shows in chart form investment returns for four management benefit funds managed by the bank. The charts reflect investment increases of from 32 to 134 percent over 3 years and appear under the headline "Unbankish Curves." See Lister, *Opportunity: The Employee Retirement Income Security Act of 1974*, in INVESTMENT COMPANY INSTITUTE, 1975 PROCEEDINGS OF GENERAL MEMBERSHIP MEETING 28, 30 for a reproduction of a bank ad featuring a "customer" who proclaims:

> Only in America! I'm 30. My salary is $10,000. I'm saving taxes on $1,500 a year.
> And I'm going to retire with $423,356 plus my social security.

309. Disclosure of performance was discussed in detail at the hearings on mutual fund distribution. *See generally* Distribution Hearings Transcript 1624-1820. The chief reasons against allowing funds to advertise performance were summed up in the written statement of Professor Henry C. Wallich:

> To advertise performance, which might be one of the more effective sales pitches, strikes me as undesirable. It should by now be obvious that good performance, when it occurs, is as likely to be the result of random events as of skillful management. Funds selling performance are selling something that they cannot promise to deliver. . . . Performance advertising, moreover, tends to produce switches from one fund to another, which in the case of funds charging substantial sales loads surely is harmful for the investor on average.

Statement of Professor Henry C. Wallich, *supra* note 267, at 5.

310. An SEC staff attorney has declared that

> the advertising amendments are relevant — indeed, vital — to the Commission's overall program to encourage a more economical and efficient mutual fund distribution system. . . . At the very least, a fund salesman should be able to do his job with considerably more ease and efficiency than he can at present.

Mendelson, *The SEC's Investment Company Advertising Rules: Why and How They*

mon sense would indicate that as investors are educated and become more sophisticated, they will be less eager to pay a stiff sales load, given the no-load purchase option. Because more consumer education should translate into less load fund sales, the content of load fund advertisments will probably be largely uninfluenced by the latest liberalization activity. Brand image-type advertising has proven to be a highly effective form of promotion for certain load funds in the past, and there is little reason to expect that they will abandon it in favor of more educational appeals. It may be noted that the advertising of regular life insurance, which is untouched by the 1933 Act, consists mainly of brand image messages. Insurers presumably have settled on this essentially non-informative type of communication because they have found it most effective.

Thus, while it is possible that in some cases load fund sales presentations will be made more efficient because prospects have been educated by the fund advertising, it is probable that the chief effect of relaxation of advertising restrictions will be to divert prospects to the no-load funds, and perhaps to encourage some load funds to shift to no-load or "low-load" status. This will, of course, make for a "more competitive environment" in the sale of mutual fund shares.[311] But the primary type of competition being spurred by the SEC's action is interbrand competition, not the intrabrand competition which is governed by section 22(d).

(c) *Payment for Promotion.* Of course, the use of advertising to spur any form of price competition will cost money, and it is doubtful whether the fund industry has the wherewithal to finance an advertising program of the size seemingly contemplated by the SEC. On this critical point of financing, the Commission and its staff have side-stepped the difficult question of whether a direct charge may be levied against fund assets to support promotional effort. In considering this question it should first be noted that it is already a common practice for fund assets to be used to subsidize distribution activities. For the no-loads, it is absolutely essential that fund assets be used to subsidize distribution activities since no sales load is imposed; if fund assets are not used at least indirectly to pay the costs of distribu-

---

Have Been Changed, MUTUAL FUNDS FORUM, Dec. 1974, at 3. For a rebuttal see Haire, *supra* note 295, at 1, 2.

311. *See* DISTRIBUTION REPORT 10 n.1.

tion, no-load funds cannot distribute.[312] Similarly, the load funds have used fund assets as a source of payment for distribution costs.[313]

In the past the SEC generally has taken the position that any subsidization of distribution other than through sales loads or redemption charges must come from the investment adviser's profits,[314] with no upward adjustment of the advisory fee allowed

---

312. Under section 10(d) of the 1940 Act, 15 U.S.C. § 80a-10(d) (1970), one type of no-load fund is expressly prohibited from incurring sales or promotional expenses. A study of expenses for mutual funds showed that no-load expense ratios tended to run .10 percent to .20 percent higher than expenses for equivalently-sized load funds. *See* NASD, AN ANALYSIS OF ALTERNATIVE METHODS OF DISTRIBUTING MUTUAL FUNDS: DIRECT MAIL ADVERTISING PROGRAMS AND GROUP SALES IV-15, Table IV-3 (1972). *See also* Distribution Hearings Transcript 483-84 (testimony of Daniel Samuel). It has been estimated that approximately 20 percent of no-loads' expenses were attributable to selling costs. *Id.* at 816 (remarks of Robert C. Porter). This state of affairs led one load fund adviser to remark:

> There is a cost of distribution throughout the mutual fund industry. For funds that make a sales charge, the largest portion of that distribution cost is paid for by the shareholder who buys the fund shares, which is as it should be. Any remaining portion of the distribution cost may be paid for by existing shareholders through a management fee paid by the fund to the adviser. For a no-load fund, the entire cost of distribution is a continuing charge paid for by existing shareholders through the management fee. Which method is more equitable?

Statement of Union Service Corp., *supra* note 262, at 3. Regardless of which method is more equitable, it would appear that the no-load system would normally be cheaper, at least for small investors. This is because the investment return earned on the amount of sales load savings realized through purchasing a no-load would normally offset the slightly higher expense ratio. For example, a 5 percent return on an 8 percent load saving would net the no-load shareholder a bonus return of .40 percent on the investment. This would usually more than offset a .20 percent higher expense ratio.

313. *See* SECURITIES WEEK, June 23, 1975, at 1; *cf.* 1 NASD STUDY at VI-79 to -80 (indicating that advisory concerns are willing to absorb losses in underwriting in order to "retain assets for management purposes"); Statement of Union Service Corp., *supra* note 262, at 3.

While in most cases these instances of use of fund assets to subsidize distribution have been indirect — payment through the advisory fee — there have in the past been direct payments for distribution through diversion of load funds' assets. *See, e.g.*, Axe-Houghton Fund B, Inc. Prospectus, Feb. 28, 1973, at 15; Group Securities, Inc. Prospectus, Feb. 28, 1973, at 9; Knickerbocker Fund Prospectus, Mar. 27, 1961, at 1. The Group Securities scheme (entailing payment to dealers of one-fourth of 1 percent of aggregate assets held by their clients "for their service as continuing points of contact with such of their customers who hold shares") has been contested in court. *See* note 316 *infra*.

314. *See* SEC, STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS 19 (1972):

> [T]he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares.

to subsidize distribution.[315] In support of the SEC's stand against subsidization of marketing costs directly out of fund assets, it could be argued that the payment of marketing costs out of fund assets could lead to excessive sales loads violative of section 22(b)(1) of the 1940 Act,[316] unreasonable discrimination which the SEC claims is prohibited by section 22(d) of the 1940 Act,[317] and a breach of fiduciary duty by the fund's investment adviser under section 36 of the 1940 Act.[318] The fiduciary duty concern, which

---

The same sentiment was expressed several years ago by SEC Commissioner Philip A. Loomis, Jr., speaking individually. PLI, THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 356 (1972). A member of the SEC General Counsel's staff has echoed that: "It is strictly a business decision whether or not to spend money on advertising, but the money spent should be the adviser's and not that of the fund shareholders." Romanski, *supra* note 282, at 1017 (footnotes omitted). On the other hand, the Commission has in the past also acknowledged that, "The fund's own resources are also used to promote sales." PUBLIC POLICY REPORT 201.

315. *See 1969 House Hearings* at 178 (testimony of SEC Chairman Hamer Budge).

316. 15 U.S.C. § 22(b)(1) (1970). Under the 1940 Act the term "sales load" is expansively defined in § 2(a)(35), 15 U.S.C. § 80a-2(a)(35) (1970), to include "fees . . . properly chargeable to sales promotional activities." There is some support for the proposition that the use of fund assets to subsidize distribution costs constitutes the imposition of a "sales load" on fund shareholders. *See* Group Securities Inc. v. Carpentier, 19 Ill. App. 2d 513, 154 N.E.2d 837 (1958). However, neither the Commission nor the staff has ever taken the position that the payment of sales and promotion expenses from fund assets necessarily would constitute a sales load. Letter from SEC Staff to Steadman Security Corp., May 22, 1975, in 2 CCH MUTUAL FUNDS GUIDE ¶ 10,201. *Cf.* note 320 *infra*. The *Carpentier* case indicates that problems may exist in satisfying the NASD sales load ceilings adopted under section 22(b)(1) should the Commission choose to make the section 22(b)(1) argument.

317. It has already been noted that the prohibition of "unfair discrimination" is one of the policies that the SEC has found to be imbedded in section 22(d). *See* note 74 *supra*. To the extent that payment of fund assets to subsidize distribution constitutes the imposition of a sales load on fund shareholders, it can be argued that the sales load is unfairly discriminatory because the size of the load borne by the shareholders would vary in an irrational fashion — according to the length of time a shareholder stayed in the fund. In response to this argument in favor of a finding of "unjust discrimination," it has been claimed that:

> nothing can be more appropriate, more "just" than that the cost of participation in a true "mutual" fund be directly related to the length of time that an investor participates. The costs of maintaining and sustaining the fund arise, are incurred, continuously over time. An investor who chooses to continue to receive the values involved in participating in the mutual fund *should* continue to bear his share of the expenses of sustaining the fund that necessarily are incurred during his participation.

Letter from Alan R. Gordon to the SEC, May 9, 1975, at 3, on file with SEC No-Action Letter to Pegasus Fund, Inc., May 21, 1975.

318. 15 U.S.C. § 80a-35 (1970). Section 36(a) gives the Commission power to seek injunctive relief as to officers, directors, investment advisers and certain other fund insiders who have engaged in, or are about to engage in, a breach of fiduciary duty "involving

seems to be the chief reason for the SEC's opposition to subsidization, appears to boil down to worry that shareholders will be forced to shoulder unreasonable costs if subsidization is approved.

The potential for abuse is greatest for the many externally managed funds. Since the management fees collected by the external adviser almost always are based on the fund's total net assets under management, an increase in assets due to more sales will almost always mean greater income for the adviser. There is thus the danger that the adviser might recommend and secure approval of subsidization arrangements that could increase sales thereby substantially benefiting the adviser without benefiting the shareholders who would foot the bill.[319] Though the potential for abuse is clear, neither the terms of the 1940 Act, its legislative history nor past SEC staff interpretations support an absolute ban on subsidization premised on the excessive load, unreasonable discrimination and breach of fiduciary duty theories.[320]

---

personal misconduct." Subsection (b) provides for private and Commission actions against investment advisers and affiliated persons for redress of breaches of fiduciary duty in connection with compensation for services or payments of a material nature made by the fund to the adviser. By definition, no fiduciary duty claim would lie under section 36(b) where the fund was internally managed. *Cf.* Letter from SEC Staff to Carl C. Shipley, May 29, 1975, in 2 CCH MUTUAL FUNDS GUIDE ¶ 10,202.

319. One way to have subsidization is to have fund shareholders make a direct contribution to dealers. Some funds have done this. *See* note 313 *supra*. Another possibility would be to provide for payments to the fund's principal underwriter. A third possibility would be to internalize the distribution function so that sales and promotion costs are borne directly by the fund rather than by the fund's principal underwriter. *See* SEC Staff Letter to Steadman Security Corp., May 22, 1975, in 2 CCH MUTUAL FUNDS GUIDE ¶ 10,201. Since the distribution function is seldom profitable in and of itself, and in fact is often subsidized by the adviser out of profits derived from management, internalization of distribution may present itself to many external advisers as a means of getting rid of a loss leader. Assuming distribution remains unprofitable and management fees are not reduced, the net effect of internalization would be to give the adviser a pay hike at the expense of shareholders.

It should be noted that some fund advisers are paid through performance fee arrangements rather than on the basis of total net assets. In such cases the external adviser is not in the same sort of conflict of interest position as can arise where fees are based on total net assets. Of course, this does not mean that an adviser whose fee is based on performance can use its influence on the fund's board to shift the burden of paying distribution costs to the fund itself where the shift would not be in the best interest of the fund.

320. In the case of section 2(a)(35) of the Act, it is not mandatory that the term "sales load" be broadly construed since the term is defined to mean "the difference between the price of a security to the public and that portion of the proceeds received from its sale which is received and invested." The section would have to be stretched to include charges against assets of the fund. *See also Hearings on S. 3580 Before a Subcomm. of the Senate*

In response to SEC arguments against allowing subsidization of promotional effort through fund assets, advocates of the practice have made numerous counter-arguments.[321] The most com-

---

Banking and Currency Comm., 76th Cong., 3d Sess., pt. 2, at 799 (1940) (where an SEC staff member explained that "the load is the difference between the amount paid by the investor and what the investment trust received") [hereinafter cited as *1940 Senate Hearings*]; Romanski, *supra* note 282, at 989-90. *But cf.* note 316 *supra*. Similarly, there is nothing in the language of section 22(d) that necessitates that it be applied to prohibit any and all unfair discrimination. In United States v. NASD, Inc., 422 U.S. 694, 715 n.26 (1975), the Court intimated that the terms of section 22(d) should be applied only to "the kind of investor discrimination sought to be remedied by this statute" and the Court made plain that the chief form of discrimination that the section was designed to confront was insider trading. *See id.* at 713-14. *See also* note 340 *infra*.

Further, a claim by the Commission that subsidization is automatically prohibited by sections 22 or 36 seems counter to past interpretations of the Act. *See, e.g.*, SEC Investment Company Act Release Nos. 7114 & 7117 (Apr. 14, 1973) (granting an investment company complex authority to charge assets for distribution expenses even though certain funds in the complex were load funds); SEC No-Action Letter to Pegasus Fund, Inc. (May 21, 1975) (giving no-action position on funds bearing distribution expenses where funds were internally managed no-loads); SEC No-Action Letter to First Safe Fund, Sept. 23, 1971, [1969-73 Transfer Binder] CCH MUTUAL FUNDS GUIDE ¶ 9376 (giving no-action position where externally managed no-load fund would bear selling and promotion expenses).

The 1940 Act's legislative history supplies slight additional support for the view that subsidization of distribution by use of fund assets is not automatically prohibited by the Act. Thus, David Schenker, an SEC attorney who was a chief architect of the legislation, explained the utility of language in section 12(b) of the Act by saying that it "protects the open-end company against *excessive* sales, promotion expenses, and so forth." *Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 112 (1940) (emphasis added). By negative implication, reasonable sales and promotion expenses are tolerable. Construction by negative implication also could be used in the case of section 10(d) of the Act to justify subsidization. That section grants certain privileges to certain no-load funds provided, *inter alia*, "no sales or promotion expenses are incurred by such registered company." 15 U.S.C. § 80a-10(d)(5) (1970). Using negative implication, funds outside the reach of section 10(d) may absorb sales and promotion expenses. In explaining the basic thrust of the Act at the 1940 Senate hearings, the SEC's chief counsel provided the following indication that interference with independent directors' business judgement would be inappropriate:

> We did not intend to mess with people who were trying to do a good job, those who have a real interest in the industry of investment, but look to special situations like Continental Securities [looting after the sale of control]. And that is all this bill contemplates.

1940 Senate Hearings 125-26 (testimony of David Schenker).

321. A recent survey of mutual fund principal underwriters conducted by the NASD showed 49 of 52 respondents answering "yes" to the question: "Does the sale of new shares materially benefit existing shareholders?" Statement of NASD, Inc., Aug. 23, 1974, at 13, SEC File No. 4-172. Among the reasons advanced by the NASD and others in favor of allowing subsidization of distribution by fund shareholders are that: growth of fund assets leads to economies of size which benefit shareholders; management can perform best when there is a steady inflow of cash; in the case of a very small fund, sales are necessary to

achieve proper diversification; and a growing asset base benefits shareholders by strengthening the management company. *See generally id.* at 12-14; Statement of Capital Research & Mgm't Co., Aug. 21, 1974, at 8-9, SEC File No. 4-172; Statement of Merrill Lynch, Pierce, Fenner & Smith, Inc., Aug. 29, 1974, at 3-4, SEC File No. 4-172; Statement of The Putnam Companies, Inc., Aug. 21, 1974, at 2-3, SEC File No. 4-172. Additional reasons in favor of allowing subsidization of distribution are presented in text accompanying notes 322-23 *infra*.

There are some problems with the above-listed reasons in favor of allowing subsidization of distribution. First consider the economies of size argument. The SEC has recognized that there are economies of size in managing investment companies. *See* PUBLIC POLICY REPORT 94-96. And it is true that an increase in the size of a fund can lead to a drop in the amount of expenses the fund may bear under applicable state law. *See* Statement of Security Mgm't Co., Aug. 21, 1974, at 2, SEC File No. 4-172. It is also true for many types of securities that brokerage commissions and dealer spreads decrease as the size of the transaction increases. The larger the fund, the greater the ability to take advantage of cost savings available through large block transactions. But to admit that size may confer benefits is not to concede that subsidization necessarily is a proper means of achieving the economies of size.

The only valid justification for allowing use of assets to achieve economies of size is the reasonable expectation that the economic benefits to be reaped by shareholders through expansion will exceed the dollar cost of achieving the economies. Since funds have historically achieved economies of size without direct subsidization of distribution costs from fund assets, it should be mandatory that proponents of subsidization establish the prospect of a tangible net economic benefit to fund shareholders before recommending a plan for director and shareholder approval. Fixing a stern burden of proof on the proponents is essential, because implementation of a subsidization program will force shareholders to assume a new and serious type of risk — the risk that management's promotional schemes will not be cost-effective. The fact that the proponents of subsidization will be standing in a fiduciary relation to the shareholders who will pay the cost is good reason for requiring clear and convincing evidence of the benefits to be achieved.

Another point concerning the "economies of size" argument is presented by an Investment Company Institute study which showed that the size of the fund's average shareholder account significantly influences a mutual fund's total expense ratio. *See* INVESTMENT COMPANY INSTITUTE, AN ANALYSIS OF FACTORS INFLUENCING MUTUAL FUND EXPENSE RATIOS 21 (1973). Managements anxious to reduce expense ratios should consider taking action with respect to minimum account size before they embark on promotional schemes aimed at boosting assets through sales to new investors.

No credence should be given to the argument that subsidization should be permitted because management performs best when there is a steady cash inflow. It is not at all clear that net redemption or closed-end status hurts performance. *See* Distribution Hearings Transcript 2139 (testimony of Michael Lipper); *The Redeemers*, FORBES, June 15, 1971, at 70, 71. Nor is it clear that size helps performance. There are some indications that the opposite is true. *See* Glazer, *A Study of Mutual Fund Complexes*, 119 U. PA. L. REV. 205, 254 (1970). Moreover, it must be recognized that the issuance of a redeemable security by a fund carries with it notice that the day must come when the asset size of the fund will level off. *See 1940 Senate Hearings* 500 (testimony of Merrill Griswold) (pointing out that redemptions tend to be a fixed percentage of assets ("around 8 or 10 percent"), making it eventually impossible for a fund continuously to sell more shares than are being redeemed).

It is likewise spurious to claim that subsidization is proper in the case of a very small fund in order to provide growth so the fund may achieve proper diversification. The three chief attributes a mutual fund offers the public are professional money management, a

pelling of these are: (1) mutual funds by their nature are self-liquidating, so that all shareholders have an interest in a continuous distribution of fund shares and should be prepared to pay the cost;[322] and (2) the business judgment of fund directors, not the iron will of a regulatory agency, should control matters of judgment about fund expenses and costs.[323] As to the first point, the SEC has conceded that the inability of a fund to successfully market its shares will eventually force the fund out of business.[324] But this concession does not necessitate automatic agreement that fund assets may be diverted to forestall liquidation. By the admission of one industry source:

> Any company that has grown and prospered in [the mutual fund] industry over a long period of time has done so primarily because of the relative effectiveness of its investment performance and its other shareholder services.[325]

---

redeemable security and diversification of risk. A fund that cannot offer the public a reasonable level of risk diversification should not be in business, much less using its assets to stimulate sales. Perhaps it is time to reconsider the efficacy of the $100,000 minimum capitalization requirement in section 14(a) of the 1940 Act, 15 U.S.C. § 80a-14(a) (1970). The $100,000 figure may be too low. Besides this fundamental objection to the diversification argument, it is questionable whether it is really very difficult for even small funds to achieve a reasonable level of diversification. The NASD's fund distribution study analyzed diversification and took the position that "one may conclude that a portfolio of eight issues has in the past provided a reasonable reduction in the level of investment risk." 1 NASD STUDY III-47. In other words, a reasonable level of diversification may be achieved through holding relatively few issues — perhaps no more than 8 or 16. *See id.* at III-46, table III-20.

The argument that a growing asset base benefits shareholders by strengthening the management company also has weaknesses. First, as was noted earlier, a fund cannot issue a redeemable security and expect to increase its total assets forever. At some point management will lose its growing asset base no matter what promotional efforts are made. Second, industry officials have pointed out that good performance and shareholder service are the most important factors in establishing a successful record of investment management in the mutual fund industry. *See* text accompanying note 325 *infra*. Thus, management already has the power to strengthen itself by attracting investors and adding to assets through performance, and by keeping those assets through providing quality services to shareholders.

322. *E.g.*, Statement of Investment Company Institute, Aug. 23, 1974, at 10, SEC File No. 4-172; Statement of NASD, Inc., *supra* note 321, at 12.

323. *E.g.*, Statement of NASD, Inc., *supra* note 321, at 14.

324. *See* Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974 at v; Haire, *Challenge: The Changing SEC Rules on Distribution*, MUTUAL FUNDS FORUM, June 1975, at 14 (quoting a statement made by a senior SEC staff member in the course of oral argument before the Supreme Court). *See also* United States v. NASD, Inc., 422 U.S. 694, 698 (1975).

325. Statement of The Putnam Companies, Inc., *supra* note 321, at 5. To the same effect see Nutt, *A Study of Mutual Fund Complexes*, 120 U. PA. L. REV. 179, 232 (1971).

As the system now stands, managements which perform well for their shareholders are rewarded. The implication is that the threat of liquidation is a serious concern only for those funds which have been poorly managed. Whether shareholders' assets should be used in an effort to increase sales in such cases is very questionable, since the risk of an unsuccessful promotional effort (in light of the fund's history of nonperformance) would seem quite significant. Shareholders of such funds who are intent on continuing with mutual fund investment have available the options of merger, or redemption and no-load reinvestment.

The business judgment argument has found favor with district courts in cases deciding the propriety of allowing fund brokerage to be used to reward dealers who sell fund shares.[326] This indicates that courts may well uphold direct subsidization on business judgment grounds when the action is authorized by a disinterested board and ratified by the fund's shareholders. It is true that the SEC has in the past railed against the utility of independent director approval and shareholder ratification as

326. *See* Tannenbaum v. Zeller, 399 F. Supp. 945 (S.D.N.Y. 1975); Moses v. Burgin, 316 F. Supp. 31 (D. Mass. 1970), *rev'd*, 448 F.2d 369 (1st Cir. 1971). The circuit court in *Moses* never reached the business judgment issue. For two competent discussions of the *Moses* litigation, each concluding that the business judgment of the fund's independent directors should govern absent nondisclosure of material facts or a showing of unfairness, see Nutt, *supra* note 325; Comment, *Mutual Funds and Independent Directors: Can* Moses *Lead to Better Business Judgment?*, 1972 DUKE L.J. 429.

The district court in *Tannenbaum* seemed to put great stock in the fact that full disclosure of the subsidization plan had been made to the disinterested directors and the shareholders. The court observed that:

> Since the fundamental purpose of the federal securities laws is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*," and thus to achieve a high standard of business ethics in the securities industry, . . . it cannot be said that any violation has been disclosed in the record.

399 F. Supp. at 955. Contrary to the impression given by the court in *Tannenbaum*, full disclosure has never been considered a sufficient means of investor protection in the mutual fund industry. This is why the 1940 Act was enacted in the face of the existing disclosure schemes set forth in the 1933 and 1934 Acts. *See The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 769-70, 794-95 (1969). *Cf.* Lipton, *Directors of Mutual Funds: Special Problems*, 31 BUS. LAWYER 1259, 1260-61 (1976). The record in *Tannenbaum* may well have furnished a legitimate basis for upholding the directors' business judgment (including reliance on counsel). The mere fact of full disclosure of the material facts about the alleged wrongdoing has no conclusive significance. The due care of the directors would still be in issue. Of course, *nondisclosure* of material facts in a subsidization case would be a breach of fiduciary duty. *See* Fogel v. Chestnutt, 2 CCH MUTUAL FUNDS GUIDE ¶ 10,246, at 13,401 (2d Cir. 1975); Moses v. Burgin, 448 F.2d 369 (1st Cir. 1971). In *Fogel*, as in *Moses*, the circuit court never reached the business judgment issue. *See* Fogel v. Chestnutt, *supra* at 13,414.

bulwarks against overreaching by investment advisers.[327] And there is surely a risk that the fund's independent directors will give in to the natural impulse to vote in favor of a plan to assist asset growth without carefully evaluating whether the expenditure of fund assets offers real benefits to fund shareholders. But it is not clear why, 36 years after the onset of SEC regulation of the mutual fund industry, a fund's independent directors should not be permitted to exercise their business judgment in deciding whether to authorize subsidization.[328]

Whether a fund's directors will want to allow fund assets to be used to subsidize advertising and other costs of distribution is another matter, particularly since the action may well generate a lawsuit.[329] As protection from such a challenge, a fund's independent directors should demand and receive hard evidence that subsidization of fund marketing efforts (which could include a generic advertising campaign) promises to be cost-effective before voting to adopt a program entailing diversion of fund assets to pay for marketing costs. Once subsidization is approved, it should be closely monitored and should cease if it becomes clear that the program is not productive.

(d) *Summary*. The Commission's fund advertising program to date may represent a "valiant, sincere effort" at reform in the eyes of the staff, but the program does not appear to furnish substantial additional assistance to fund marketers. Moreover, it

---

327. *See, e.g.*, PUBLIC POLICY REPORT 148-49 (calling shareholder ratification a "wholly inadequate and almost illusory means" of shareholder protection, and taking the position that even if an externally managed mutual fund's board was composed entirely of independent directors, there still "would not be an effective check on advisory fees and other forms of management compensation").

328. For a case history of fund independent director action which indicates that independent directors are worthy of the trust of the SEC and the courts, see Internalizing Mutual Fund Management: The Vanguard Group Experience, Address by John C. Bogle, FBA-CCH Mutual Funds and Investment Management Conference, Palm Springs, Calif., Mar. 12, 1975, copy on file with the *South Carolina Law Review*.

329. It is pertinent to note the reply one securities industry executive gave to the SEC when asked about the desirability of allowing funds to pay a continuing fee to dealers out of fund assets. The executive gave a number of reasons why the proposal presented difficulties, among which was the following:

> At the present time, independent directors of any fund are not prone to see management fees or other expenses increased—no matter what the designation. This comes about due to the many strike suits, the 1970 Act amendments and decisions in several court cases. To place an additional fee into the expense structure would be a hard selling job on many directors.

Letter from Whitney Bradley, Mar. 5, 1973, at 1-2, SEC File No. 4-164.

is not enough for the Commission and the staff to wrestle with the perceived dictates of the 1933 Act; an equally important issue is the practical question whether fund assets may be used to pay for advertising. There is, in short, much room for improvement of the Commission's approach to fund advertising.

There are signs that improvements will be forthcoming. Speaking individually, a Commissioner and a senior staff member recently have given hope that advertising strictures will be further streamlined and, perhaps more importantly, that the Commission may be willing to allow the use of assets to subsidize distribution in certain cases.[330] Future efforts at liberalization are desirable, and hopefully the Commission's plan of action will be more bold and creative than has previously been the case. Perhaps the time has come for the Commission and the fund industry to join together to ask Congress to recognize that mutual funds offer unique investment advantages to the public and deserve special marketing freedom not available to other issuers of securities. Within the mutual fund family it is time that attention be given to granting special benefits to funds that provide distinctive benefits to investors. For example, internally managed no-load funds should arguably have greater marketing flexibility since the cost to investors and the risk of conflicts of interest are minimized.

b. *Group Sales Rules*. Group insurance has been a spectacular marketing success,[331] with a proven record of affording substantial cost savings to the public.[332] In recognition of the

---

330. *See* Haire, *supra* note 295, at 2, 11-12.

331. The first group policy of any significance was written in 1912 by the Equitable Life Assurance Society on the lives of nearly 3,000 Montgomery Ward employees. National Ass'n of Insurance Commissioners., *The Mass Merchandising of Property and Liability Insurance*, in 1 1972 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 90, 132. Sixty years later, group life coverage exceeded one-half trillion dollars, a figure approaching the amount of individual life outstanding. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1972, at 25. Group health insurance currently contributes three dollars for every dollar advanced through regular policies. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1975, at 54. Group annuity premium receipts now exceed individual annuity receipts by 300 percent. *Id.* Further, group auto insurance policies are said to have increased tenfold in the space of five years. *See* Bulkeley, *Car Pools*, Wall Street J., June 26, 1973, at 1, col. 6.

332. For example, a comparison of expenses as a percentage of premiums of non-group life insurance with group life insurance for five leading mutual companies (Prudential, New York Life, Metropolitan, John Hancock and Equitable and three leading stock companies (Aetna Life, Connecticut General and Travelers) for 1971 showed expenses for non-group coverage averaging 27.0 percent of premiums while group life expenses averaged

economies of distribution that group marketing offers, the Commission's fund distribution program included two measures designed to encourage mutual fund interest in mass merchandising. First, the Commission amended rule 22d-1[333] to permit price discounts to: (1) all employer-employee groups, and (2) any organized group (with certain exceptions) which has been in existence for more than six months and has some purpose other than buying fund shares.[334] Second, in August of 1975 the Commission proposed new rule 22d-4 to permit reduced load sales to existing fund shareholders at the same time that shares are being offered at full sales loads to new investors.[335] Implementation of either proposal would be strictly voluntary.

A number of features about the two rules deserve comment. First, the push for liberalization originated with the Commission rather than with the industry,[336] which says something about the fund industry's hunger for creative marketing approaches — at least as to those approaches which are perceived to threaten the primary distribution systems (fund - underwriter - dealer). Neither group sale possibility has been applauded by the industry,[337]

5.9 percent of premiums. In every case the expense ratio for non-group life was more than double that for group life. *See Life Insurance Hearings*, pt. 1, at 18, table C.

333. 17 C.F.R. § 270.22d-1 (1975).

334. *See* SEC Investment Company Act Release No. 8569 (Nov. 4, 1974). The exceptions to the general rule of allowing group sales to any organized group older than six months make it generally impermissible to sell to credit cardholders of a company, policyholders of an insurance company, and customers of either a bank or broker-dealer or clients of an investment adviser. 17 C.F.R. § 270.22d-1(b) (1975). The release introducing the amendment noted that the listing of exceptions "may be narrowed or expanded by further amendment to the rule if experience shows that it would be appropriate." SEC Investment Company Act Release No. 8569, at 3 (Nov. 4, 1974).

335. SEC Investment Company Act Release No. 8894 (Securities Act Release No. 5607) (Aug. 19, 1975).

336. Though both rules were formulated by the SEC in the absence of strong fund industry interest or support, it deserves mention that rule 22d-4 was foreshadowed by no-action positions taken by the SEC's staff concerning requests for permission to make cut-rate offerings submitted by Schuster Fund and Manhattan Fund. *Cf.* Letter from SEC Division of Investment Management Regulation to Manhattan Fund, Inc., Oct. 11, 1974, *reprinted in* 2 CCH MUTUAL FUNDS GUIDE ¶ 10,156.

337. *See* DISTRIBUTION REPORT 90; Haire, *supra* note 324, at 32; 2 CCH MUTUAL FUNDS GUIDE No. 179, Oct. 10, 1975, at 506 (reporting reaction to the SEC's shareholder discount proposal). Additional criticism of the staff's shareholder discount idea is presented in Proyect, *A Look at Reality*, MUTUAL FUNDS FORUM, Apr. 1975, at 1, 2, 8. Among other things, Proyect picked on the shareholder discount plan as economically unfeasible due in part to the high cost of furnishing a prospectus to each shareholder advised of the discount. The proposal was eventually drafted to obviate the need for prospectuses in communications to shareholders advising them of their right to purchase at a discount.

and this lack of enthusiasm for allowing discounts on sales to fund shareholders is particularly striking since additional purchases of fund shares by shareholders under the present system often may require payments for unnecessary and unexpended selling effort. As was noted earlier, it is arguable that a fund management owes a special obligation to fund shareholders to see that shareholders are not overcharged on their fund investments,[338] and a case can be made that shareholders are overcharged when they are compelled to pay for a service they do not want or get. Furthermore, a cut-rate offering price to shareholders may be a desirable means of generating an inflow of cash for a fund — possibly more desirable and defensible than the use of assets for promotion. The reduced load option at least has the virtue of providing an easily identifiable benefit to shareholders.

Another interesting aspect of the Commissioner's discount rules relates to the character of the rules themselves. Both are drafted to exempt transactions from the coverage of section 22(d). Why these rules are needed is not immediately clear. Section 22(d) contemplates that shares may be offered at different prices to different classes of investors. Note that the section prevents sales of investment company securities "except at a [not *the*] current offering price described in the prospectus."[339] Under both the group sales rule (rule 22d-1) and the shareholder discount proposal (proposed rule 22d-4) the offering prices for sales to the pertinent groups are required to be stated in the offering fund's prospectus. Since offerors under the "exemptive" rules are required to do precisely what section 22(d) demands, it may be asked just from what have they been exempted. With neither the

---

Proyect also criticized the discount idea on the ground that sales personnel would be reluctant to introduce shareholders to funds if the customer would be offered an opportunity to purchase shares at no-load in the future. On this score, it is worth noting that proposed rule 22d-4 does not require that sales to repeat investors be at no-load. Funds and underwriters are left free to charge a load on the repeat investment and then pass on all or a portion of that load to dealers who render continuing assistance to shareholders who purchase under the rule.

338. *See* note 229 *supra* and accompanying text. Of course, in considering whether to reduce loads on repeat purchases by shareholders, managements would want to weigh the prospect of injury to the fund in the event the load reductions caused a decrease in dealer enthusiasm and a drop in sales to new investors.

339. The text of section 22(d) is set forth in part at note 232 *supra*. The legislative history of section 22(d) reflects that the use of "a" instead of "the" was intentional. *See* Baum v. Investors Diversified Services, Inc., 286 F. Supp. 914, 926 (N.D. Ill. 1968), *aff'd*, 409 F.2d 872 (7th Cir. 1969).

language of section 22(d) nor the policies underlying the section appearing to prohibit offerings permitted by the new rules,[340] it would seem that the Commission's rulemaking merely empowers funds to adopt previously legal pricing practices.

Just as it is not clear why funds need an SEC exemption from

340. Three main policies have been ascribed to section 22(d). First, it has been said that the section was designed to eliminate a price-competitive secondary market in mutual fund shares conducted by so-called "bootleg" (non-contract) dealers which disrupted the mutual fund distribution system in the 1930s. *See* United States v. NASD, Inc., 422 U.S. 694, 715 (1975); Greene, *supra* note 232, at 370-73. *But see* Comments of U.S. Dep't of Justice, *supra* note 39, at 31, 35. Second, it has been said that section 22(d) was designed to prevent dilution made possible by a price system that permitted "riskless" trading in fund shares by insiders. *See* United States v. NASD, Inc., *supra* at 713-14 & n.24; Heffernan & Jorden, *supra* note 232, at 979-84, 997-98; Comments of the U.S. Dep't of Justice, *supra* note 39, at 31-35. Third, it has been claimed by the SEC "that preventing discrimination among investors was one of the purposes of section 22(d)." United States v. NASD, Inc., *supra* at 715 n.26; *cf.* note 74 *supra*. Section 22(d) by its terms permits price discrimination. *See* note 339 *supra* and accompanying text. Thus, the antidiscrimination policy the SEC finds in 22(d) really is directed towards preventing "unjust" discrimination. The validity of reading section 22(d) as a basis for outlawing any and all forms of unjust discrimination in fund pricing has been contested. *See* Heffernan & Jorden, *supra* note 232, at 994-98, 1007.

The rules will not encourage dilution. Concern over dilution ceased to be a concern when the system for pricing mutual fund shares that allowed riskless trading was abolished in 1968. *See* 17 C.F.R. § 270.22c-1 (1975). As for the threat of disorderly distribution, neither rule 22d-1, as amended, nor proposed rule 22d-4 contravenes the orderly distribution policy since any competition would be among underwriters and not retailers as was the case with the "bootleg" market problem. Finally, assuming that section 22(d) can be read broadly to proscribe "unfair discrimination" in pricing, this policy is not subverted since price variances under the rules are to be based on the rational grounds of differences in cost and service, and hence are not unfairly discriminatory. *Cf.* DISTRIBUTION REPORT 93.

It deserves mention that the language of section 22(d) might by negative implication cast doubt on the propriety of shareholder discounts in certain cases. After setting forth the basic prospectus disclosure requirement the statute states:

> Nothing in this subsection shall prevent a sale made . . . (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities) . . . .

15 U.S.C. § 80a-22(d) (1970). It could thus be argued that the drafters meant that discount sales to shareholders are improper unless made: (1) when offers to the general public are suspended; and (2) in amounts reflecting proportionate share ownership. This construction may seem far-fetched, but the SEC staff has in the past required that offers to nonshareholders be suspended when discount sales are made to shareholders. *E.g.*, SEC No-action Letter to Manhattan Fund, Inc., May 29, 1975. Apparently the staff sought to impose the condition in an attempt to bring the discount offers within the statutory exemption. Under proposed rule 22d-4 it would not be necessary for the fund to suspend offers to the general public and no limitations on the amount of shares that could be purchased would be required.

section 22(d) to make sales as permitted by the amended rule 22d-1 and proposed rule 22d-4, so also it is unclear from whence the SEC derives the authority it purports to exercise in amended rule 22d-1 to bar the availability of quantity discounts to certain groups, such as holders of a given credit card.[341] Is it defensible to permit a fund and its underwriter to make group sales to *XYZ* Department Store's employees, but bar them from also making sales to *XYZ*'s credit customers? Where in the 1940 Act is there authority to chill marketing initiative by funds and their underwriters through such distinctions?[342] From what risk is the SEC protecting the industry by drawing such lines? Is it the risk that such offers might result in lower prices? Do discounts voluntarily offered by certain load funds to large groups pose greater risks to the traditional load fund distribution system than the "discounts" widely advertised by the no-load funds?

It is difficult to understand why the SEC should be able to make it unlawful[343] for any fund to share economies of distribution with any group, so long as sales are made at a current offering price described in the fund's prospectus. It is particularly difficult to reconcile the Commission's apparent desire to "keep the lid on" use of group sales techniques with the thrust of two past SEC letters to Congress announcing the Commission's hope for "the

341. *See* note 334 *supra* and accompanying text for transactions not eligible for quantity discounts. *See* Letter from SEC Division of Investment Management Regulation to F. Eberstadt & Co., March 14, 1975, *reprinted in* 2 CCH MUTUAL FUNDS GUIDE ¶ 10,176, for an application of the exclusionary language.

342. The releases announcing the two rules cite as authority for promulgation of the exemptions sections 6(c), 22(d) and 38(a) of the 1940 Act. 15 U.S.C. §§ 80a-6(c), 80a-22(d) & 80a-37(a) (1970). Section 6(c) gives general exemptive authority to the SEC. Its utility is thus restricted to those occasions where a practice would be illegal but for an exemption. Section 22(d), the second source of SEC authority, speaks of SEC exemptive authority only in terms of rules made pursuant to section 12(b) of the Act, 15 U.S.C. § 80a-12(b) (1970). Neither rule 22d-1 nor 22d-4 qualifies under that provision, since neither is promulgated under section 12. Section 38(a) simply gives the Commission authority "to make, issue, amend, and rescind such rules . . . as are necessary or appropriate to the exercise of the powers conferred on the Commission elsewhere in this subchapter . . . ." The section is thus a dead end as a primary source of exemptive authority for the rules in question. For a close analysis of section 22(d)'s background and its alleged manipulation by the SEC and the fund industry see Heffernan & Jorden, *supra* note 232. The authors conclude that "[b]oth the SEC and the industry have assisted in the perversion of the legislative history of section 22(d)." *Id.* at 994. The authors claim that, among other things, this so-called perversion furnished a basis for the adoption of rule 22d-1 in 1958. *Id.* at 995-97.

343. Violation of any SEC rule under the 1940 Act is punishable via civil and criminal actions. *See* 15 U.S.C §§ 80a-41, 80a-48 (1970).

development of lower cost distribution systems"[344] and the Commission's conclusion that personal selling is "an inefficient and expensive method of distribution."[345] If the Commission sincerely wants to achieve a "more competitive environment" through innovation and efficiency in fund distribution, it should take the wraps off marketing initiative — or at least be able to point to clear authority for prohibiting experimentation.

c. *Combination Discounts.* Rulemaking under section 22(d) has not been the only means used by the Commission in its attempt to bring about intrabrand price variances in the marketing of load funds. In addition to promulgating its group sales and shareholder discount rules, the Commission has acted informally to sanction price reductions where mutual funds are sold in combination with other financial products distributed by the same underwriter.[346] The justification for the Commission's announced intention to "view favorably applications for exemption from 22(d) to permit combination discounts"[347] is that the cost reductions are justified by "more efficient delivery of the selling service."[348] Perhaps because it does not promise to change the status quo in load fund distribution, the combination discount idea seems to be the part of the SEC's fund distribution program that has been singled out for the most praise by fund industry execu-

344. Letter from SEC Commissioner Richard B. Smith to the President of the Senate and the Speaker of the House of Representatives, March 10, 1971, in INSTITUTIONAL INVESTOR REPORT, *supra* note 12, pt. 8, at xix.

345. Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at iv. The letter went on to state that "the mutual fund industry's historic reliance upon high fixed sales charges to induce salesmen to 'push' fund shares, besides being expensive for investors, is simply not working today." *Id.*

346. The plan, as outlined by the staff is

> that underwriters be permitted to offer reduced or eliminated sales loads on mutual fund shares where the investor has (1) previously or contemporaneously purchased (2) from the same retailer (3) certain other types of investment products (including but not limited to insurance) (4) which are available at a separately stated price and which are (5) distributed by the same principal underwriter or a company affiliated with such underwriter.

DISTRIBUTION REPORT 98-99 (footnotes omitted).

347. Letter from SEC Chairman Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at vi.

348. DISTRIBUTION REPORT 99 n.2. This justification differs from the SEC staff's rationale for discounts to repeat investors ("the supposition that the sales 'push' would be replaced by a demand 'pull,' with the customer taking the initiative in order to obtain a lower price"), and the justification for group discounts (a combination of the demand "pull" and "more efficient delivery" theories). *Id.*

tives.[349] The concept of making combination offerings apparently originated with the fund industry[350] and, as was the case with discounts on group sales and sales to repeat investors, it is hardly remarkable that the SEC is willing to "exempt" such offerings from section 22(d) provided, presumably, that the combination sales are made at a current offering price described in the fund's prospectus. What truly would be remarkable would be for a court to find a fund in violation of section 22(d) for offering combination discounts reflecting "more efficient delivery of the selling service" where the prospectus disclosure dictate of section 22(d) was satisfied.

4. Encouraging Brokered Sales

As part of its fund distribution program the Commission asserted its opposition to contractual restraints on development of a secondary brokered market in mutual fund shares.[351] An individual would use such a market to sell fund shares to another, through an agent. Like its counterpart, the secondary dealer market,[352] a secondary brokered market offers benefits to investors. Purchasers through the secondary market would likely benefit from lower prices, and the market could be expected to put competitive pressure on prices charged for shares purchased through the load funds' primary distribution systems. A secondary market also offers advantages to selling shareholders, since they should be able to obtain quicker execution and possibly more money for

349. *E.g.*, Haire, *supra* note 304, at 32-33. It remains to be seen whether insurance will be successful as a combination product for discount marketing. The staff's distribution report expressed concern that some states might view discounts on fund shares sold in conjunction with life insurance as constituting unlawful discrimination or rebates. DISTRIBUTION REPORT 98 n.4.

350. *See* DISTRIBUTION REPORT 97-100.

351. Letter from Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at vi. This missive was quickly followed by Letter from Ray Garrett, Jr. to Gordon S. Macklin, Nov. 22, 1974, which formally notified the securities industry of the Commission's position.

352. Through a secondary dealer market, dealers, acting as principals, would purchase shares for their own account for shareholders and sell them to other investors. It has been said that trading in such a market was made illegal by section 22(d) in order to protect the fund industry's primary distribution system from disruption. *Cf.* note 340 *supra*. It should be noted that while section 22(d) calls for a form of retail price maintenance in sales by dealers to the public, "[b]y its terms, § 22(d) excepts interdealer sales from its price maintenance requirement." United States v. NASD, Inc., 422 U.S. 694, 711 (1975). A number of firms have participated in an interdealer secondary market. *See* SECTION 22(d) REPORT, pt. 2, at 292-95.

their shares than they would by redeeming them with their funds at net asset value.

There is little novel in the Commission's support of the legitimacy of a secondary brokered market. The SEC has maintained since 1941 that section 22(d) is inapplicable where an individual sells shares to another individual through a broker.[353] In its most recent position statement on brokered transactions, the Commission did go a step further by revealing its intention to exercise its regulatory authority to keep the development of a brokered market from crippling the load funds' primary distribution systems.[354] The Commission's action had been foreshadowed by an earlier staff recommendation that steps be taken to protect fund underwriters.[355] The rationale for protecting fund underwriters (largely by allowing them to assess a service fee when shares are transferred) is that brokers in the secondary market have an unearned advantage since they benefit from the promotional efforts of fund underwriters without making a contribution to the cost of creating a demand for fund shares.[356]

The most interesting aspect of the Commission's restatement of its long-held position on secondary brokered markets concerns the timing of the announcement. At the time of the Commission's action there was pending before the Supreme Court an antitrust injunction action instituted by the Department of Justice against certain mutual funds, fund underwriters, broker-dealers, and the NASD.[357] The suit charged a conspiracy, contracts, and

---

353. The SEC's position was initially stated in an opinion of the SEC's General Counsel published in 1941. SEC Investment Company Act Release No. 78 (March 4, 1941). This view has been reiterated in subsequent SEC opinions. *See* Oxford Co., Inc., 21 S.E.C. 681, 690 (1946); Mutual Funds Advisory, Inc., SEC Investment Company Act Release No. 6932 (1972). *See also* DISTRIBUTION REPORT 104, 105 n.2.

354. Letter from Ray Garrett, Jr. to Gordon S. Macklin, Nov. 22, 1974.

355. Specifically: (1) a fund should be able to impose a reasonable flat transfer fee; (2) orders should not be filled more than one full business day after they were received; and (3) a fund should be able to obtain an exemption from any rule under Section 22(f) upon a showing of a threat to its distribution system.

DISTRIBUTION REPORT 109.

356. *See id.* at 106 n.1; *cf.* SECTION 22(d) REPORT, pt. 1, at A-121. Of course, underwriters are not the only group that would be placed in a difficult position by the development of a secondary brokered market. Brokers who are also fund dealers would seem to face a dilemma with respect to their obligation to secure the best price. The staff noted this problem but did not offer a solution. *See* DISTRIBUTION REPORT 108 n.3.

357. *In re* Mutual Fund Sales Antitrust Litigation, 374 F. Supp. 95 (D.D.C. 1973), *aff'd sub nom.* United States v. NASD, Inc., 422 U.S. 694 (1975). The government's

combinations among the defendants to restrict the sale of, and fix the resale prices for, mutual fund shares through a variety of actions, including restraints on the development of a secondary brokered market.[358] The defense to the brokered market allegations was that sections 22(d) and 22(f)[359] of the 1940 Act conferred antitrust immunity upon the practices, and the district court agreed.[360] The ruling as to section 22(d) immunity is curious, given the failure of section 22(d) to refer to brokers.[361]

The Supreme Court in *United States v. National Association of Securities Dealers, Inc.*,[362] a five-to-four decision,[363] rejected the district court's reading of 22(d), relying in part on the SEC's interpretation of section 22(d)'s coverage.[364] Though it refused to view section 22(d) as providing the industry with a safe harbor, the Court ultimately ruled for the defendants on all counts, finding that SEC oversight of mutual fund distribution practices legitimized the defendants' private restrictions and insulated the practices from antitrust attack.[365] Mr. Justice White, in dissent, blistered the majority for bending over backward to immunize practices from the antitrust laws in the face of a tradition that " 'exemptions from the antitrust laws are strictly construed' and that implied exemptions are 'strongly disfavored.' "[366] Interest-

---

lawsuit was decided with a private action filed shortly before the government suit was docketed. An appeal from the district court's dismissal of the complaints was stayed by the Court of Appeals for the District of Columbia pending resolution of the *NASD* case by the Supreme Court. 422 U.S. at 700 n.5.

358. See 422 U.S. at 701-03 for a breakdown of the allegations in the eight-count complaint.

359. 15 U.S.C. § 80a-22(f) (1970). The section provides that no

> registered [mutual fund] shall restrict the transferability or negotiability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the Commission may prescribe in the interests of the holders of all the outstanding securities of such [mutual fund].

360. *See In re* Mutual Fund Sales Antitrust Litigation, 374 F. Supp. 95, 109 (D.D.C. 1973).

361. See note 232 *supra* for the relevant language of section 22(d).

362. 422 U.S. 694 (1975).

363. The majority opinion was written by Justice Powell and joined in by Chief Justice Burger and Justices Blackmum, Rehnquist and Stewart.

364. *See* United States v. NASD, Inc., 422 U.S. 694, 717-20 (1975).

365. The Court found certain of the allegedly illegal practices immunized from antitrust attack by section 22(f) of the 1940 act. The remaining instances of alleged wrongdoing, involving claims of a horizontal conspiracy, were held impliedly immunized because of the pervasive supervisory authority with which the SEC is vested by the Maloney Act, 15 U.S.C. § 78o-3 *et seq.* (1970).

366. United States v. NASD, Inc., 422 U.S. 694, 744 (1975) (White, J., dissenting).

ingly, the Commission participated in the case as amicus curiae and took the side of the defendants in arguing for antitrust immunity as to alleged vertical restrictions on secondary market activities, notwithstanding the Commission's opinions that: (1) no provision of law restrained the development of secondary brokered markets, and (2) contractual restraints on development of a secondary brokered market were untenable.

If there is any solid reasoning in the SEC's plea for immunity and the majority's opinion, it has perhaps less to do with reconciling antitrust precedents with the 1940 Act's regulatory scheme than with a belief that the SEC is in a better position than the antitrust courts to monitor and supervise the workings of the fund industry.[367] Despite its declared opposition to the contractual restraints, the Commission to date has not pushed vigorously for

---

The dissent went on to make the telling point that:

> It is especially interesting to find the Court on the one hand concluding that the selling practices under scrutiny here are essential to the working of the statutory scheme but on the other hand recognizing that the Commission itself has requested that the NASD rules be amended to prohibit agreements between underwriters and broker-dealers that preclude broker-dealers, acting as agents, from matching orders to buy and sell fund shares at competitively determined prices and commission rates.

Id. at 747-48. For argument that Justice White was correct in arguing against the implication of immunity, see *The Supreme Court, 1974 Term*, 89 HARV. L. REV. 47, 208-11 (1975).

367. At the conclusion of the majority's opinion the Court noted:

> [W]e have implied immunity in particular and discrete instances to assure that the federal agency entrusted with regulation in the public interest could carry out that responsibility free from the disruption of conflicting judgments that might be voiced by courts exercising jurisdiction under the antitrust laws . . . . In this instance maintenance of an antitrust action for activities so directly related to the SEC's responsibilities poses a substantial danger that appellees would be subjected to duplicative and inconsistent standards. This is hardly a result that Congress would have mandated.

United States v. NASD, Inc., 422 U.S. 694, 734-35 (1975). This comment should be read in light of footnote 5 of the majority's opinion, which pointed out:

> Subsequent to the filing of the United States' complaint some 50 private suits purporting to be class actions under Federal Rule Civ. Proc. 23 were filed in various district courts around the country.

Id. at 700 n.5. It is worth recalling that in recent years the Supreme Court has worked hard to narrow the scope of exposure in class action cases. *See e.g.*, Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975); Eisen v. Carlisle & Jacqueline, 417 U.S. 156 (1974); Zahn v. International Paper Co., 414 U.S. 291 (1974); Snyder v. Harris, 394 U.S. 332 (1969); *cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (a 10b-5 class action affirming the so-called *Birnbaum* doctrine with the majority expressing concern "that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good." *Id.* at 748). *See generally* note 161 *supra*.

development of a secondary brokered market for fund shares. According to an NASD official, the fund industry is reluctant to take any action on the Commission's request for a prohibition of restraints on the development of a secondary brokered market until all civil suits related to the Justice Department's challenge are settled.[368] Thus the extent of any benefits to investors flowing from development of a secondary brokered market in fund shares remains to be seen.

V. CONCLUSION

Early in this article it was noted that there are striking parallels in the marketing positions of the life insurance and mutual fund industries.[369] Two reasons help explain why these parallels exist. First, marketing in each industry takes place in the shadow of a statutory price maintenance scheme that generally is viewed as severely limiting opportunities for intrabrand price variances. A conclusion of this article is that the statutory limitations are not as confining as companies and regulators may believe or wish. The second reason for parallels between mutual fund and life insurance marketing is that both industries are built around products that are classified as intangibles. Intangibles are not easy to explain to the public. They can be successfully marketed in the large market of unsophisticated customers by use of personal selling, with the selling effort creating the demand for the product. Reliance on personal selling means relying on people. So long as the products are marketed this way there will be inefficiencies in distribution, there will be unethical companies and sales personnel, and there will be room for increasing the amount of price competition in the marketplace.

Improved cost disclosure at the point of sale should help some life insurance purchasers save money. It is meaningless, however, to a great many other people who cannot understand the data, or who are willing to put their faith in the salesperson who contacts them, or who elect to purchase from a high cost company for brand image or other reasons. To think of cost disclosure at

368. Letter from Paul L. Butler to John P. Freeman, Oct. 24, 1975, on file with the *South Carolina Law Review*. The private litigation continues to grind on, though the Supreme Court's ruling in the *NASD* case was dispositive of many contested points. *See* Haddad v. Crosby Corp., 2 CCH MUTUAL FUNDS GUIDE ¶ 10,269 (D.C. Cir. Feb. 17, 1976).

369. *See* notes 24-39 *supra* and accompanying text.

the point of sale as a cure-all to the insurance industry's lack of vigorous price competition is to ignore the experience of the mutual fund industry which historically has been dominated by the load funds in the face of very thorough cost disclosure provisions. In any event, cost disclosure at the point of sale is probably not the most significant development to come out of the cost disclosure movement. Probably a more significant result of the movement is the new-found cost consciousness of insurance companies which has led low cost companies to use cost as a selling point. Here the parallel between life insurers and mutual funds breaks down, because most low cost life insurers, unlike most no-load mutual funds, have sufficient economic resources to use advertising effectively.[370]

Another healthy side-effect of the cost disclosure movement in the life insurance market is the attention it has focused on the serious lapsation and sales force turnover problems burdening the life insurance industry. It is time to consider correcting the lapsation problem through legislation aimed at reducing the front-end load sales incentive which may be in large part responsible for unsuitable whole life sales. There is precedent for this. Lapsation rates in the sale of mutual fund contractual plans once paralleled those currently existing for whole life policies.[371] Congress reacted in 1970 by writing substantial investor protection measures into section 27 of the 1940 Act.[372] On the other hand, a legislative

370. *Cf.* note 295 *supra*.

371. It was noted earlier that a Senate subcommittee's survey of 55 companies disclosed an average 13-month lapse rate of 17.2 percent for new whole life policyholders. *See* note 219 *supra* and accompanying text. A 1962 study of lapse rates for holders of mutual fund contractual plans by the SEC disclosed that approximately 17 percent of the surveyed planholders lapsed their plans so early that they ended up paying sales loads of 50 percent. *See* 4 SPECIAL STUDY, *supra* note 8, at 191. After weighing this and other factors, the report recommended that "serious consideration should be given to the elimination of future front-end load plans." *Id.* at 211.

372. *See* 15 U.S.C. § 80a-27(d)-(h) (1970). These provisions were added to the Investment Company Act in 1970. Among other things, the new subsections require that if a mutual fund is sold pursuant to a periodic payment plan with a 50 percent first-year sales load, the purchaser is entitled to cash in his or her holdings at any time during the first 18 months after issuance and receive the value of his or her investment plus the excess of any sales load paid over 15 percent of the total payments made. Written notice of this sales charge refund privilege must be given by the 16th month of investment ownership to any shareholder who has missed 3 or more payments. Investors also benefit from the generous free-look option noted earlier. *See* note 185 *supra* and accompanying text. As harsh as these and other restraints on front-end loading of fund sales may be, they represent a retreat from the SEC's first choice for coping with front-end loads: abolition. PUBLIC

solution might not be necessary if insurers themselves were willing to provide disincentives for lapses, such as forfeiture of commissions. A less direct but probably equally useful way of cutting lapses is by upgrading sales force quality. But this is easier said than done, and some of the most attractive marketing opportunities available to a life insurer involve bypassing the sales force altogether through the use of mass merchandising programs which pass on cost savings to purchasers.

Any attempts to pass cost savings on to the purchasers through mass marketing are likely to be vigorously opposed by sales personnel fearful of losing commission income. The legality of innovative mass marketing plans may be challenged by opponents claiming that such arrangements lead to unfair discrimination, illegal rebates and suitability problems. These claims have been rejected in the past when other mass marketing efforts have been implemented.[373] Of course, the mere legality of mass marketing does not necessarily make it practical. A loss of sales force

---

POLICY REPORT 247. Legislation to accomplish this result was introduced in Congress in 1969. *See* S. 296, 91st Cong., 1st Sess. § 16 (1969). The Commission's chief complaint with the use of the front-end load in the marketing of the plans centered on the high effective sales charges borne by lapsing planholders. PUBLIC POLICY REPORT 246-47. The SEC's concern over lapsation losses traces back to the findings of its *Special Study of the Securities Markets*. *See* note 371 *supra*.

The effect of the 1970 additions to section 27 was outlined at the mutual fund distribution hearings by David D. Grayson, President of First Investors Corp., who testified: "It is obvious today, as I say, the sponsors are really struggling. I mean more of our sponsors are going out of business all the time. The salesmen are not earning a living." Distribution Hearings Transcript 652. The effect of the 1970 amendments on contractual plan sales was particularly adverse for Piedmont Capital Corporation, among others. To avoid the 18 month refund right burden Piedmont ceased charging a front-end load of 50 percent on its plan sales in April 1971. The new load was a maximum of 20 percent of the first year payments. Piedmont's plan sales dropped from nearly $80 million in 1970 to less than $40 million in 1971, to less than $2 million in 1972. Statement of Piedmont Capital Corp., Jan. 31, 1973, at 2, SEC File No. 4-164. As to the legitimacy of equating installment sales of life insurance with sales of mutual funds through periodic payment plans, the SEC is on record as holding that "there is no basis for analogizing the purchase of . . . insurance on the installment basis to front-end load plans for investing in mutual fund shares." PUBLIC POLICY REPORT 245. Not surprisingly, this passage has been quoted back to the SEC by parties interested in seeing variable life insurance exempted from sales load limitations such as those found in section 27 of the 1940 Act. *See* NAIC VLI Comments, *supra* note 59, at 52; Statement of NARe Life Services Co. (undated), at 8, SEC File 4-149.

373. *Cf.* notes 69 and 76-77 *supra*. The two sides to the debate over mass marketing are summarized in NAIC, *The Mass Merchandising of Property and Liability Insurance*, in 1 1972 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 90, 132. A more detailed presentation of the pros and cons of mass merchandising group insurance is presented in S. KIMBALL & H. DENENBERG, MASS MARKETING OF PROPERTY & LIABILITY INSURANCE 40-92 (1970).

allegiance might offset any momentary advantage gained through an upsurge in sales resulting from mass marketing efforts. At the same time policyholders, particularly policyholders of mutual companies, can legitimately argue that they require less personal selling than first-time customers and deserve rates reflecting this fact. Otherwise, the argument would run, they are discriminated against by being forced to subsidize a higher cost market segment — one that not only costs more to solicit, but may well be more prone to costly lapsation.

However difficult may be the choices facing the life insurance companies, their managements and sales forces can take consolation in the knowledge that the mutual funds and their sales forces have a much worse situation. The marketing problems facing the mutual funds seem innumerable, but several stand out. First there is the nature of the product. A fixed death benefit is easier to deliver than investment "performance."[374] It has been said that funds that sell performance are selling something they cannot be sure they will be able to deliver.[375] Customers become unhappy when their expectations are disappointed. Nor is the performance promise which is implicit in fund investment the only aspect which is suspect and troublesome; load funds have another built-in source of customer discontent: the load itself. Customers may not be pleased to find out about no-loads after purchasing a load fund. They may believe that they were duped, and their resulting unhappiness may be a cause of redemptions. A study by one large load fund revealed that seventeen percent of the cash turned back

374. One mutual fund executive stressed the importance of investment performance in mutual fund marketing as follows:

> To me, the most important criterion in selling is to have a good product. To the mutual fund industry, this means performance. By this, I don't mean that you have to be first every year, but I do think you have to have above average investment performance.
>
> This whole subject of performance gets kicked around a good bit as you all know, but I'm not talking about good performance in one year and then a bad year. I'm talking about *consistency* of performance. This is what a person wants when he invests money in a fund. Most of our shareholders, I am sure, are long-term investors.
>
> Performance, to me, is terribly important. It's our product. And this applies to all of us.

Schaeffer, *No-Load Sales: Maintaining Momentum*, MUTUAL FUNDS FORUM, Feb. 1972, at 5. *Cf.* note 300 *supra* and accompanying text.

375. *Cf.* note 309 *supra*. For a recent review of the random walk theory, see Laing, *On the Average*, Wall Street J., Nov. 12, 1975, at 1, col. 6.

to redeeming shareholders was destined for reinvestment in no-load funds.[376]

Apart from product problems, the mutual funds have the further difficulty of contending with SEC regulation. The SEC has been zealous in discharging its investor protection responsibilities under the 1940 Act — so zealous, in fact, that its activism has possibly caused some investors to shun mutual funds in favor of more expensive and less suitable investment vehicles.[377] While the SEC's "more competitive environment" program has a noble objective, there is reason to doubt its existence will dramatically alter the fund marketing landscape. In the area of advertising the SEC seems to hope the new flexibility resulting from liberalization of restrictions will somehow make sales personnel more efficient.[378] As a practical matter, relaxation of restraints promises to be of value principally to the no-loads. Load funds stand to gain little since the more mutual fund advertising educates investors, the more load funds stand to lose from prospects switching to the no-loads. If the aim of advertising is to pre-condition the prospect to make the load fund dealer's job easier, then brand image advertising, not educational advertising, would seem more effective. It is worth recalling that even though life insurers' advertisements are not within the scope of the 1933 Act, they still dwell primarily on brand image appeals.

The segments of the SEC's program dealing with exemptions from section 22(d) (particularly group discounts, sales to shareholders and combination discounts) raise some fundamental questions: Why are these exemptions necessary? Is it actually illegal under the 1940 Act for a fund to offer nondiscriminatory price discounts to its own shareholders? What statutory language

376. *See* Rubens, *supra* note 36, at 64.

377. *Cf.* note 263 *supra*. Fund industry spokesmen are not reluctant to lay some of the fund industry's marketing problems at the SEC's doorstep. *E.g.*, SEC Regulation of Mutual Funds: Images and Realities, Address by David Silver, 1973 Mutual Funds Conf. in Mexico City, Mar. 6, 1973, *reprinted in* 193 BNA SEC REG. & L. REP., at D-1 (Mar. 14, 1973). The SEC has shown itself willing to shoulder a portion of the responsibility for past inefficiencies in fund marketing effort. Indeed, the cornerstone of the Commission's "more competitive environment" program is the judgment that it is time to move away from "past restrictive Commission interpretations with respect to section 22(d)." Letter from Ray Garrett, Jr. to Senator John Sparkman, Nov. 4, 1974, at iv. On the other hand, it is clear that the bulk of the marketing problems that have faced the fund industry in recent years are not the fault of the SEC. *See, e.g.*, Regan, *A Message for Mutual Funds*, MUTUAL FUNDS FORUM, Oct. 1972, at 1.

378. *See* note 309 *supra* and accompanying text.

or particle of legislative history leads to such a notion?[379] By its exemptive rules, the SEC has apparently converted section 22(d) into a sort of switchboard through which it has undertaken to control marketing innovation in the fund industry. It is difficult to see how the SEC can maintain control of innovation without discouraging it, and frustration of initiative in what is really a marketing industry is not a happy result. At the same time, there is a positive side to the SEC's action since, by its rule-making, the SEC may stimulate rapid adoption of useful and valuable marketing innovations that would take years to gain widespread acceptance through the normal pressures of competition. The industry benefits in two ways by the SEC's actions. First, it is made clear that adopting the innovation will not lead to liability. Secondly, action taken by a fund and its underwriter to implement the "authorized" practice is done pursuant to an SEC rule, rather than being a purely unilateral action. The net result is the same, but from a dealer-relations standpoint the fund and its underwriter may be better off if the SEC is seen as the source of a marketing practice that leads to a cut in dealer compensation. On the other hand, since implementation of the SEC's marketing programs is voluntary, dealers would have to be very slow-witted to view the SEC as the only culprit in the event commissions are cut.

As part of its program, the SEC announced its intention to request from Congress authority to take a range of actions concerning mutual fund distribution, including prohibition of retail price maintenance. Thus it appears that the battle of section 22(d) is not over; its site simply will be shifting from an SEC hearing room to Capitol Hill. When the new hearings convene, perhaps both the SEC and the industry will see fit to present to Congress not only charges and counter-charges concerning section 22(d)'s utility, but also new proposals aimed at making the distribution of mutual funds more efficient. For example, appealing arguments can be made for allowing advertising of performance and for reducing prospectus delivery requirements to allow greater use of mass merchandising techniques. Consideration should also be given to offering special benefits to certain types of funds. Perhaps an internally managed no-load index fund

379. *See* note 340 *supra* and accompanying text.

should enjoy unique marketing advantages since such an investment vehicle would offer both a substantially reduced opportunity for conflicts of interest and significant cost savings.

The point is that the retail price maintenance issue is significant, but not the only issue in the fund distribution field. At any future hearings into mutual fund distribution, there should be study of concrete, common sense proposals aimed at streamlining the marketing of fund shares to save money for investors. Hopefully, the SEC and the fund industry will join hands to request the help of Congress in achieving efficiencies in marketing. Meanwhile, the need for more "exemptive" rules under section 22(d) is doubtful. The time has come for section 22(d) to be demythologized.