

INFORMATIONAL MEMORANDUM

February 7, 1978

TO : The Commission
FROM : The Division of Investment Management
SUBJECT : Meeting with the Investment Company Institute on February 9, 1978 to discuss various issues concerning mutual funds.

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The Commission is scheduled to meet with the Investment Company Institute ("ICI") at 2:30 on February 9, 1978, to discuss various issues concerning mutual funds. At the request of Chairman Williams, the ICI submitted an outline (Attachment A) of the topics proposed for discussion. In order to assist the Commission, we have prepared briefing materials. For convenience, these briefing materials follow the ICI's outline of its proposed discussion. In the following discussion, the ICI's subject headings are underlined.

If the ICI follows its outline, it will devote its presentation to advertising. Before we go through the ICI's outline item by item, it might be helpful to give an overview. Advertising generally speaking includes three types of communications -- Rule 134 "tombstone" ads, sales literature, and Rule 434a summary prospectuses. For some time the ICI has been interested in bringing all advertising under a single Advertising Code. It seems to be interested in an amendment to Rule 134 that would exempt mutual fund advertising from the definition of a prospectus or, perhaps, exempt such mutual fund advertising as complies with the code, from the definition of a prospectus. Rule 134 was adopted under Section 2(10)(b) which provides, generally, that an advertisement is excepted from the definition of a prospectus if it:

"does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary of appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit "

The ICI seems to believe that the authority to permit advertisements to contain "other information" is sufficiently broad to permit advertisements which contain all types of information, including portrayals of past performance. In addition, the ICI, apparently, would like advertisements which complied with the advertising code to be safe from any challenge under any provision of the securities laws.

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The Division has serious reservations about the ICI's recommended approach because we doubt that the statutory scheme can be bent so far. Advertisements excepted from the definition of a prospectus would, as a result, not be a basis for rescission under Section 12(2) of the Act even if securities were sold by means of misleading advertisements. Furthermore, while the Act specifically excepts from the definition of a prospectus sales literature accompanied or preceded by a full prospectus, the ICI approach would except sales literature without requiring that it be accompanied or preceded by a prospectus.

We believe that Congress intended that advertisements excepted from the definition of a prospectus and, thus, not subject to Section 12(2) liability, should be either advertisements containing only limited information or advertisements accompanied or preceded by the full statutory prospectus. The words "other information" in the statute must be read together with the specific types of information enumerated in Section 2(10)(b) and interpreted in a way consistent with the spirit of the Act. The Division has tried to do that in recommending various expansions of Rule 134 over the last five years. Under the Statement of Policy, we have permitted sales literature, which must be accompanied or preceded by a prospectus, to discuss important disclosure items such as past performance in a relatively specified way. We note that the Commission has expressed the concern that detailed regulation of sales literature may provide too much of a safe harbor. Such a concern would seem to apply even more to advertising. The traditional view, which we believe is basically correct, is that advertising should call attention to the prospectus and that the prospectus should be the major selling document.

A. INTRODUCTION

1. Basic principles relating to mutual fund advertising

The Securities Act of 1933 restricts advertising by all issuers, including investment companies. Section 2(10) of the '33 Act includes an advertisement, written or by radio or television, in the definition of a prospectus, and Section 5 prohibits the use of a prospectus which does not meet the requirements of Section 10. Section 10(a) of the '33 Act prescribes the requirements for a full statutory prospectus, the one which must be delivered in connection with the sale of a security.

However, there are three provisions in the Act which permit the use of written communications which are not in the form of Section 10(a) prospectuses. Two are exemptions from the definition of a prospectus, and the third is a Section 10(b) prospectus. (1) Section 2(10)(a) of the '33 Act permits the use of sales literature if it is preceded by or accompanied by a statutory prospectus. The Commission has issued a Statement of Policy concerning the use of sales literature in connection with the sale of mutual fund shares. As the Commission knows, the Division is reevaluating the Statement of Policy. (2) Section 2(10)(b) permits the so-called "tombstone" advertisement.

Rule 134 under the '33 Act regulates these advertisements. (3) Section 10(b) '33 Act authorizes the Commission to permit the use of a prospectus which omits in part or summarizes information in the statutory prospectus. Rule 434a under the '33 Act pertains to summary prospectuses.

2. Review of Present Advertising Rules, Recent Commission Actions and Institute Submissions

Prior to 1972, Rule 134 permitted inclusion of the name of the issuer, the full title of the security, the amount being offered and a brief description of the general type of business of the issuer limited in the case of an investment company registered under the 1940 Act to: (1) The company's classification and sub-classification under the Act, (2) whether it was a balanced, specialized, bond, preferred stock, or common stock fund, and (3) whether in the selection of investments emphasis was placed upon income or growth characteristics.

In 1972, the rule was amended to permit a general description of an investment company including its general attributes, methods of operation and services. Certain logos and advertising devices and designs were also permitted.

In 1974, the rule was further amended to permit identification of the investment adviser and the use of attention-getting headlines not involving performance figures. Open-end companies were allowed to include (1) a description of the company's investment objectives and policies, services and method of operations; (2) identification of the company's principal officers; (3) the year of incorporation or organization or period of existence of the company, its investment adviser or both; (4) the company's aggregated net asset value as of the most recent practical date; (5) the aggregate net asset value as of the most recent practical date of all registered investment companies under the management of the company's investment adviser; and (6) any pictorial illustration contained in the company's prospectus and not involving performance figures. A legend calling attention to the prospectus was required. In 1975 the rule was amended to soften the legend requirement.

In 1977, in Securities Act Release No. 5833 ^{1/} the Commission proposed an amendment to Rule 134 to permit funds which has filed registration statements which had not yet become effective to use Rule 134.

^{1/} A copy of this release and the Division's memorandum recommending it are attached hereto as Attachments B and C.

Also in Release 5833 the Commission proposed Rule 434d which would permit registered investment companies which have filed a registration statement to advertise so long as any such advertisement (1) appears in a newspaper or magazine of general circulation or on radio or television, (2) contains only information the substance of which is included in the Section 10(a) prospectus, (3) states conspicuously from whom a prospectus containing more complete information may be obtained and that an investor should read that prospectus carefully before investing, (4) is limited to no more than 600 words, excluding required legends, and charts and graphs and (5) if used prior to effectiveness of the registration statement, contains the statement required by Rule 433(b). ^{2/} This proposed rule is discussed in more detail below under heading B.

Also discussed in more detail below under headings C and D is the Statement of Policy.

3. Constitutional Framework for Regulation of Mutual Fund Advertising

In its comments on proposed Rule 434d, ^{3/} the ICI asserted that it is becoming clear that there are Constitutional limits on the Commission's "authority to censor mutual fund advertising or to enact substantive rules which do not reflect the limitation on governmental authority made necessary by the First Amendment." The ICI said it would elaborate separately. The ICI has received a memorandum from Professor David Ratner concerning the implications of recent Supreme Court decisions which indicate that commercial speech is protected under the First Amendment to the Constitution. The Division has seen the memorandum, and the General Counsel's Office is reviewing it now. Very briefly, Professor Ratner's argument appears to suggest that Section 5 of the '33 Act as applied to mutual funds may violate the First Amendment of the Constitution. He also criticizes the proposed limitations in Rule 434d. Ratner argues that the Commission should take action under the '33 Act only against misleading mutual fund advertisements. The staff does not believe that the Supreme Court intended to invalidate the

^{2/} The rule requires a legend concerning that a registration statement has been filed but has not become effective, and that sales may not be made prior to effectiveness.

^{3/} See Attachment D.

'33 Act pattern of regulation although the staff did cite certain recent Supreme Court decisions as one of its reasons for proposing greater freedom in investment company advertising. 4/

As we said earlier, the ICI is requesting in effect that (1) the Commission exempt mutual fund advertisements from the requirements of Section 5 of the '33 Act by exempting such advertisements from the definition of a prospectus and (2) that the Commission with the help of the industry define which advertisements containing selling information such as past performance data are not misleading. This would give the users of such advertisements immunity from suit under the '33 Act and the '34 Act.

4. Need for a comprehensive regulatory approach to mutual fund advertising rather than ad hoc rule-making.
5. Problems created by ad hoc rule-making exemplified by proposed Rule 434-d and 1977 Commission proposals relating to performance charts and tables.

These two topics may be considered together. The ICI believes that the rules and regulations governing mutual fund advertising constitute "a jerry-built" system of overlapping and conflicting rules. The ICI believes that the Commission needs to take a fresh start in the whole area of mutual fund advertising and that the first step is revision of the Statement of Policy as soon as possible. The ICI believes that the Statement of Policy can then form the basis for a mutual fund advertising Code which it has been recommending for a number of years. Our concerns about this approach are outlined at the beginning of this memo. Briefly, we believe the statute requires that "advertisements" which contain more than limited information describing general characteristics of the fund must either be a prospectus or be accompanied by one.

4/ See, Virginia State Board of Pharmacy, et al. v. Virginia Citizens Consumer Counsel, Inc., et al., 425 U.S. 748 (1976), in which the Supreme Court in holding that state restrictions on the advertising of prescription prices of drugs were in violation of the First Amendment, said (at p. 765): "Advertising ... is ... dissemination of information as to who is producing and selling what product, for what reason, and at what price. So long as we preserve a predominantly free enterprise economy, the allocation of our resources in large measure will be made through numerous private economic decisions. It is a matter of public interest that those decisions, in the aggregate, be intelligent and well informed. To this end the free flow of commercial information is indispensable."

B. Proposed Rule 434d

1. Reasons for liberalized advertising rules for mutual funds

Investment companies have contended that the general scheme of regulation has a particularly adverse effect upon them for three reasons. First, unlike other companies, they sell only one product: their shares. If they cannot advertise their shares, they cannot advertise the company. Since they offer their shares continuously, any advertisement for the company is an advertisement of their shares and, therefore, a prospectus which is illegal unless it complies with statutory requirements. As a result, investors cannot learn about investment companies, as they can learn about other companies, from advertisements of their products. Second, investment companies represent a unique concept and unless the public can be educated about the concept and unless the public can be educated about the concept they will be ignorant of it and uninterested in it. (A 1971 study showed that there were 13 million families in the United States with annual incomes exceeding \$10,000 who knew nothing about mutual funds.) Third, institutions such as savings and loan institutions and insurance companies, which compete with investment companies for investor interest, are not subject to the same limitations on their advertising as are investment companies.

2. Revisions in advertising rules since 1972 (revised tombstone Rule 134; generic advertising Rule 135A; summary prospectus Rule 434A(a)).

- A. The revisions of Rule 134 since 1972 were discussed earlier.
- B. Rule 135a provides that advertisements which are about investment companies but does not specifically refer to any particular investment company (so called generic advertisements) will not be deemed to offer any security for sale provided certain conditions are met.
- C. Rule 434a is the summary prospectus rule. It contains rather detailed requirements as to the content of summary prospectuses. The ICI contends that such summary prospectuses are rarely used because they cannot be accompanied by supplemental sales literature.

The ICI is correct that not much use is made of summary prospectuses. Reasons in addition to the one advanced by the ICI may be that summary prospectuses are too long to be included in advertisements in public media and that sales literature accompanied or preceded by a statutory prospectus is exempt from the definition of a prospectus but communications accompanied or preceded by a summary prospectus are not.

3. Experience under revised rule

In its comments on proposed Rule 434d the ICI made the following comment which might give some indication of what the ICI can be expected to say about the experience of funds under the present advertising rules:

"Each rule explicitly sets forth its own requirements and prohibitions and each rule has spawned its own set of unwritten "dos" and "don'ts" which change on a day-to-day fund-by-fund basis. Adding to the confusion is the fact that often it is impossible to determine which particular rule applies to a specific advertisement. Further, the SEC staff rarely issues no-action or interpretive releases in this area: current staff positions generally are explained to particular issuers and underwriters on a private, unpublished basis. Finally, the structure of the industry subjects the advertisements of some firms to review by both the Commission staff and the NASD; other firms' advertisements are subject to review only by the SEC staff."

4. Proposed Rule 434d

In its comment on proposed Rule 434d, the ICI advanced three basic criticisms. First, the ICI objected to the fact that the proposed rule would only apply to advertisements in newspapers or magazines of general circulation. The ICI was concerned that such advertisements could not be used in direct mail by themselves by a full prospectus.

The reason for the restriction was to preserve the full prospectus as the basic selling document. The proposed rule is intended to cover those situations where a full prospectus cannot accompany or precede the advertisement, such as when the advertisement is in a newspaper. When an advertisement can be accompanied or preceded by the full prospectus, the reason for the new rule no longer applies and it is, therefore, not necessary that the rule apply to such a situation. Second, the ICI contended that the proposed rule was a non-rule because it did not specify what types of information must or must not be included in advertisements. We thought that this was a virtue of the proposed rule contrasted, for example, with the summary prospectus

rule. But it seems that the ICI prefers to have the Commission define a safe harbor that would permit advertisements containing portrayals of past performance. Finally, the ICI argued that the proposed rule would create an anomaly in that certain information would be clearly proper under Proposed Rule 434d and vice versa. We do not see this as an anomaly since an advertisement which complied with the provision of either rule would be permissible. As noted earlier, the Commission has expressed doubts about the extent to which the Statement of Policy provides a safe harbor for sales literature. At least sales literature must be accompanied or preceded by a statutory prospectus.

In conclusion, it seems that the ICI would like the Commission to adopt an amendment to Rule 134 that would permit any information to be included in a mutual fund advertisement and would except such advertisement from the definition of a prospectus. If this were done, sales made by reason of such advertisements could not be rescinded by the purchasers pursuant to the provisions of Section 12(2) of the Act even if such statements were misleading.

The ICI also seems to want the Commission to work with it to create an advertising code which, presumably, would be enforced by some industry body. It is our guess that it would be the industry's position that any advertisement that complies with the code should be safe from any challenge under the securities laws.

We are wary of providing a safe harbor of this kind even assuming that it would be permitted by the statute.

C. Illustrating performance

1. History of Statement of Policy and need for revisions to reflect current conditions

In 1950, the Commission, with the assistance of the NASD, reviewed samples of advertising and supplemental sales literature used in the sale of investment company shares. This review led to the issuance by the Commission of a Statement of Policy so that issuers, underwriters and dealers might understand certain of the types of advertising and sales literature which the Commission considered might be violative of the statutory standards. The Statement was amended in 1955 and 1957.

Perhaps even more significant has been the use of the Statement as a "safe harbor" for the industry in its preparation and use of sales literature, particularly illustrations of performance (charts and tables); although users of sales literature are permitted to use any sales literature which is not misleading, they have tended to limit their use of sales literature to those types specifically approved in the Statement as not misleading. Thus, in some respects, the impact of the the Statement has been similar to that of a rule forbidding the use of presentations not specifically approved.

The ICI, since at least 1975, has indicated its desire for an overall revision of the Statement. The length of time since the 1957 amendments, the developments in the industry in the interim (e.g., the introduction of money market funds, suggesting the computation and presentation to investors of yield figures on a basis more current than that now sanctioned by the Statement) and the reluctance of the industry to use appropriate presentations unless they are included in the Statement, suggest that a review of the Statement is in order. The Commission has initiated a general review of the Statement.

2. Commission's 1974 proposed new charts and table and Institute's 1975 submission of entire revised Statement of Policy
3. Commission's 1977 new charts and tables

Essentially, the charts proposed in 1974 were the "total return" charts adopted by the Commission in September 1977 and January 1978. While the ICI, in 1975, welcomed the Commission's proposal to include "total return" charts, it objected to the complexity of the specific charts proposed and also recommended a revision of the entire Statement. The charts as adopted eliminated much of the over-complexity of the charts as proposed.

4. Institute's 1977 letter of technical comments

The ICI made certain technical comments on the total return charts adopted by the Commission. 5/ A number of minor suggestions were made with respect to Chart E, and major changes were suggested for Chart F (a bar chart which is optional for use with Chart E, a "mountain" chart).

While the staff believes that some of the ICI technical comments have merit, they were received too late to incorporate in our recommendation to the Commission in December, 1977, and none was considered so significant as to warrant delay of the Commission's action on the charts in January 1978. All the the ICI comments will, of course, be considered in connection with the overall review of the Statement.

5. Charts and tables contained in Institute's 1977 revision of entire Statement of Policy

The ICI has submitted its version of a revised Statement. 6/

5/ Attachment E

6/ Attachment F

6. Limitation of new charts and tables to 10 years and Commission's proposal to limit all charts and tables to ten years

(a) Justifications set forth in Commission's release

(b) Institute's views

The Commission, in its action in January 1978 relating to the adoption of the total return charts, decided to remove the ten-year limit from those charts and decided not to impose a ten-year limit on other charts.

7. Commission's proposal to require use of new Sample Chart E with any other performance chart

(a) Apparent justification

(b) Institute's views

Although the Commission decided not to implement this requirement at this time, the Commission has expressed strong concern with respect to the performance history of different funds being presented on a comparable basis. Accordingly, the Commission may find it opportune to obtain the views of the ICI on the matter of comparability.

D. Statement of Policy

1. Commission's 1977 request for comments to make the Statement of Policy more workable and effective

The staff is now in the process of considering the comments submitted in connection with that review and anticipates recommending to the Commission that it publish, as a proposal as to which comment is invited, any proposed revision of the Statement of Policy or alternative thereto.

2. Institute's 1977 submission of entire revised Statement of Policy

This document is attached. 7/

3. Desirability of developing a mutual fund advertising Code to replace all existing tombstone rules and the Statement of Policy

As discussed above, the approach taken by the ICI blurs the distinction between sales literature, which can be used only with a full prospectus, and advertising, which under the securities laws is excepted from the definition of a prospectus only if it contains limited kinds of information.