NEWS

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# MUTUAL FUND ADVERTISING

An Address by Roberta S. Karmel, Commissioner
Securities and Exchange Commission

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ADDRESS BY ROBERTA S. KARMEL, COMMISSIONER
SECURITIES AND EXCHANGE COMMISSION*
MUTUAL FUNDS AND INVESTMENT MANAGEMENT
CONFERENCE
TUCSON, ARIZONA - MARCH 16, 1978

# MUTUAL FUND ADVERTISING

LAST WEEK, CHAIRMAN WILLIAMS ANNOUNCED THE SELECTION OF SYD MENDELSOHN AS DIRECTOR OF THE DIVISION OF INVESTMENT MANAGEMENT AND A REEXAMINATION OF THE RELATIONSHIPS WHICH HAVE EVOLVED BETWEEN THE COMMISSION AND THE MUTUAL FUND INDUSTRY. CHAIRMAN WILLIAMS STATED THAT "THE OBJECTIVE OF THIS REVIEW WOULD BE TO SEARCH FOR WAYS IN WHICH THE INDUSTRY . . . CAN BE ENCOURAGED TO ASSUME GREATER RESPONSIBILITY FOR THE ADMINISTRATION OF THE BUSINESS ACTIVITIES OF PERSONS REGULATED UNDER THE INVESTMENT COMPANY AND INVESTMENT ADVISERS ACTS, WHILE AT THE SAME TIME PRESERVING THE COMMISSION'S ABILITY TO ENSURE THAT REQUIREMENTS OF THE FEDERAL SECURITIES LAWS ARE SATISFIED." THE CHAIRMAN THEN WENT TO CHINA, PRESUMABLY TO SEEK OUT NEW MODELS FOR MUTUAL FUND REGULATION AND SENT SYD AND ME TO THIS CONFERENCE, PRESUMABLY TO SEEK OUT NEW RELATIONSHIPS WITHIN THE MUTUAL FUND INDUSTRY.

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IN ANY EVENT, I AM DELIGHTED TO BE HERE, AND I INTEND TO SPEAK TO YOU THIS MORNING ON A SUBJECT ON WHICH YOU HAVE ASKED FOR AND SHOULD RECEIVE GREATER RESPONSIBILITY FOR YOUR BUSINESS ACTIVITIES -- INVESTMENT COMPANY ADVERTISING.

LAST MONTH, THE INVESTMENT COMPANY INSTITUTE SENT DAVE SILVER TO THE COMMISSION TABLE TO PLEAD YOUR CASE FOR REGULATORY REFORM IN THE DISTRIBUTION OF MUTUAL FUND SHARES, PARTICULARLY WITH RESPECT TO INVESTOR COMMUNICATIONS. DAVE ABLY EXPRESSED YOUR DISSATISFACTION WITH THE PRESENT REGULATORY SCHEME, WHICH HE CHARACTERIZED AS "A CONFUSED MASS OF OVERLAPPING AND SEEMINGLY ARBITRARY RULES." SINCE EACH OF THE AMENDMENTS TO THE SEC'S RULES OVER THE PAST FIVE YEARS HAS BEEN CHARACTERIZED BY US AS AN EXTENSIVE LIBERALIZATION, DAVE DID NOT ASK FOR ANY FURTHER LIBERALIZATION OF THE RULES. INSTEAD HE ASKED FOR A SYSTEM OF ADVERTISING RESTRICTIONS WHICH WOULD PERMIT MUTUAL FUND PROMOTIONAL LITERATURE TO BE CIRCULATED ON THE SAME BASIS AS HARD-CORE PORNOGRAPHY. I HAVE GIVEN THAT PROPOSAL MY ATTENTION, AND CONCLUDED THAT IN VIEW OF THE ADMONITIONS IN THE 1975 ACT AMENDMENTS THAT THE COMMISSION MUST CONSIDER THE EFFECTS OF ITS RULEMAKING ON COMPETITION, WE WOULD BE UNABLE TO COUNTENANCE THAT SORT OF A TIE-IN ARRANGEMENT.

I BELIEVE THAT THE PROBLEMS OF MUTUAL FUND DISTRIBUTION ARE DIRECTLY RELATED TO THE PROBLEMS OF CAPITAL FORMATION AND THAT THE PROPOSALS WHICH THE ICI MADE TO THE COMMISSION ON FEBRUARY 9 DESERVE A SERIOUS RESPONSE. WHILE I AM ONLY HERE TO SPEAK FOR MYSELF AND NOT FOR THE COMMISSION, AS ALL OF YOU KNOW, I HOPE THAT MY ADDRESS TODAY CAN CONTRIBUTE TO A MEANINGFUL DIALOGUE BETWEEN THE COMMISSION AND THE INDUSTRY CONCERNING THE EXPENSES OF MUTUAL FUND DISTRIBUTION. I WOULD LIKE TO BEGIN BY SETTING FORTH MY UNDERSTANDING OF THE ICI'S PROPOSAL, SO THAT YOU CAN CORRECT ME IF I MISUNDERSTOOD DAVE SILVER'S PRESENTATION.

THE ICI HAS SUGGESTED THAT THE SEC ADOPT A SINGLE ADVERTISING RULE WHICH WOULD REPLACE ALL EXISTING RULES DEALING WITH THE REGULATION OF ADVERTISING OF MUTUAL FUNDS. THE ESSENCE OF THIS PROPOSED RULE WOULD BE THE PROHIBITION OF FRAUDULENT OR MISLEADING COMMUNICATIONS TO PROSPECTIVE PURCHASERS OF MUTUAL FUNDS' SHARES. AS A PART OF THIS PROPOSED RULE, THE ICI SUGGESTS THAT WE ESTABLISH AN "ADVERTISING CODE" WHICH WOULD ENUNCIATE THE COMMUNICATIONS WHICH THE COMMISSION FINDS CLEARLY MISLEADING AND WHICH WOULD ESTABLISH A LIMITED NUMBER OF "SAFE HARBOR" EXAMPLES, PARTICULARLY IN THE AREA OF TABLES, CHARTS AND OTHER GRAPHIC REPRESENTATIONS. UNDER THE PROPOSAL, ADVERTISEMENTS WOULD INDICATE THE NECESSITY FOR OBTAINING A STATUTORY PROSPECTUS BEFORE A FINAL SALE COULD BE CONSUMMATED.

According to responses to questions which I asked during the ICI's presentation to the Commission, if communications under the proposed rule satisfy the advertising code included within the rule, then those communications would be exempted from the definition of a "prospectus" as that term is used in Sections 5 and 12 of the Securities Act of 1933. Should any communications violate that code, then such communications would remain prospectuses for the purposes of Sections 5 and 12. False or misleading advertisements would also violate the anti-fraud provisions of the securities laws. The role of the Commission's staff and of the NASD in administering this proposed new rule was left unclear, particularly with regard to whether there would be any mechanism established whereby particular advertisements would be pre-cleared before use.

In our mass consumer-oriented society, advertising has become increasingly respectable as a communications as well as a sales vehicle. A variety of economic and legal developments has presuaded the mutual fund industry that it is burdened by obsolete and unnecessary restrictions on its ability to communicate with the public, as well as sell its products.

NET SALES OF MUTUAL FUND SHARES IN JANUARY TOTALED $172.4 MILLION, THE LARGEST MARGIN OF SALES OVER REDEMPTIONS IN THREE YEARS, AND FOR ALL OF 1977, THERE WERE NET SALES OF $373.5 MILLION. NEVERTHELESS, DURING THE FIVE PRECEDING YEARS, 1972 TO 1976, NET REDEMPTIONS OF MUTUAL FUND SHARES TOTALED $6.1 BILLION. FURTHER, THE RECENT REVERSAL OF THE NET REDEMPTION TREND IS DUE IN LARGE PART TO SALES OF MUNICIPAL BOND FUNDS. EQUITY FUNDS REMAIN IN THE DOLDRUMS.

I WOULD LIKE TO SEE THE SALES OF EQUITY FUNDS INCREASE, JUST AS YOU WOULD, BECAUSE THAT WOULD INDICATE THAT NEEDED CAPITAL INVESTMENT IN OUR PUBLIC CORPORATIONS IS OCCURRING. I AM DISTRESSED THAT THE GOVERNMENT, BY WAY OF MUNICIPAL BOND OFFERINGS OR OTHERWISE, IS BECOMING INCREASINGLY RESPONSIBLE FOR RAISING INVESTMENT CAPITAL. AS A COMMISSIONER AT THE SEC, IT WOULD BE EASIER TO PRESIDE OVER A HEALTHIER SECURITIES INDUSTRY, THRIVING IN A BETTER ECONOMY. THEREFORE, I WISH YOU WELL IN YOUR EFFORTS TO IMPROVE UPON EXISTING MUTUAL FUND DISTRIBUTION ARRANGEMENTS. BUT, I AM PERSONALLY SKEPTICAL THAT MORE AGGRESSIVE ADVERTISING WILL SELL YOUR PRODUCTS WHEN THE ECONOMIC INCENTIVES TO BUY THEM ARE LACKING.

NEVERTHELESS, I DO BELIEVE THAT THE MUTUAL FUND INDUSTRY IS ENTITLED TO COMPETE ON FAIR TERMS WITH OTHER FINANCIAL INSTITUTIONS FOR THE INVESTMENT DOLLAR. IN RECENT YEARS, MUTUAL FUNDS HAVE EXPERIENCED INCREASED COMPETITION FROM OTHER FINANCIAL INSTITUTIONS AND MONEY MANAGERS AS A PART OF A GENERAL INCREASE IN COMPETITION BETWEEN THE SECURITIES INDUSTRY AND THE BANKING AND INSURANCE INDUSTRIES. TO THE EXTENT THAT SUCH COMPETITORS ARE FREE FROM REGULATORY RESTRAINTS AND ARE ABLE TO USE MORE AGGRESSIVE ADVERTISING TECHNIQUES, THE MUTUAL FUND INDUSTRY HAS JUSTIFIABLE COMPLAINTS.

BY REASON OF THE SECURITIES ACT AMENDMENTS OF 1975 AND RECENT DECISIONS IN VARIOUS AREAS, THE COMMISSION MUST INCREASINGLY CONSIDER THE ANTI-COMPETITIVE ASPECTS OF OUR RULES, AND THE BURDEN OF NEW RULES ON COMPETITION. IN THE CONTEXT OF SUCH CONCERNS, THE COMMISSION SHOULD CONSIDER CAREFULLY THE EFFECT OF ADVERTISING REGULATION UPON THE ABILITY OF NEW MUTUAL FUNDS TO ENTER THE MARKET-PLACE, THE ABILITY OF MUTUAL FUNDS TO COMPETE WITH OTHER FINANCIAL INSTITUTIONS FOR INVESTMENT DOLLARS, AND THE ABILITY OF SMALL FUNDS TO SURVIVE IN COMPETITION WITH LARGER FUNDS.

ANOTHER FACTOR WHICH HAS AFFECTED THE IMPORTANCE WHICH THE MUTUAL FUND INDUSTRY ATTACHES TO ADVERTISING IS THE RELATIVELY RECENT INCREASE IN THE INDUSTRY'S USE OF NO-LOAD. IN 1977, NO-LOAD SALES ACCOUNTED FOR 48% OF ALL SALES (INCLUDING MONEY MARKET SALES), AS COMPARED WITH ABOUT 10% IN 1970. THE INCREASE IN THE ROLE OF NO-LOAD UNDOUBTEDLY IS RELATED TO THE DISCONTINUANCE OF THE USE OF "SOFT DOLLARS" OF BROKERAGE ALLOCATION TO SELL THEIR SHARES.

THERE ALSO HAVE BEEN CHANGES IN THE LEGAL CLIMATE SURROUNDING THE REGULATION OF ADVERTISING IN GENERAL. SEVERAL RECENT SUPREME COURT CASES DEALING WITH THE APPLICABILITY OF THE FIRST AMENDMENT TO COMMERCIAL SPEECH, INCLUDING ADVERTISEMENTS, HAVE HELD THAT SUCH SPEECH IS NO LONGER WHOLLY OUTSIDE THE PROTECTION OF THE FIRST AMENDMENT. NEVERTHELESS, COMMERCIAL SPEECH MAY BE REGULATED BY THE GOVERNMENT IF SUCH REGULATIONS ARE REASONABLY RELATED TO VALID GOVERNMENTAL OBJECTIVES. FURTHER, THE FIRST AMENDMENT DOES NOT PROVIDE LICENSE FOR COMMERCIAL SPEECH WHICH IS FALSE, MISLEADING OR DECEPTIVE.

IN 1976, THE SUPREME COURT IN VIRGINIA STATE BOARD OF PHARMACY V. VIRGINIA CONSUMERS COUNCIL, 425 U.S. 748 (1976), INVALIDATED A VIRGINIA STATUTE PROHIBITING PRICE ADVERTISEMENTS BY PHARMACISTS OF PRESCRIPTION DRUGS.

THE COURT REFERRED TO A FUNDAMENTAL RIGHT OF CONSUMERS TO RECEIVE INFORMATION AND TO THE ESSENTIAL ROLE OF ADVERTISING IN PROVIDING INFORMATION NECESSARY TO THE FUNCTIONING OF AN ECONOMY SUCH AS OURS. THE COURT DID NOT, HOWEVER, APPLY ITS TRADITIONAL TEST UNDER THE FIRST AMENDMENT ACCORDING TO WHICH ANY GOVERNMENTAL PROHIBITION ON SPEECH IS INVALID UNLESS SUPPORTED BY A "COMPELLING INTEREST". RATHER, THE COURT UTILIZED A BALANCING TEST WHEREBY THE REGULATION WAS EXAMINED TO DETERMINE WHETHER THE STATE'S LEGITIMATE REGULATORY OBJECTIVES COULD BE ACHIEVED WITH LESS INFRINGEMENT OF FIRST AMENDMENT RIGHTS.

LAST YEAR, THE SUPREME COURT, IN BATES V. STATE BAR OF ARIZONA, ____ U.S. ____, 97 S.CT. 2691 (1977) RULED THAT A STATE COULD NOT IMPOSE A BLANKET SUPPRESSION OF ADVERTISEMENT OF ROUTINE LEGAL SERVICES. THE COURT FOUND IT "PECULIAR TO DENY THE CONSUMER, ON THE GROUND THE INFORMATION IS INCOMPLETE, AT LEAST SOME OF THE RELEVANT INFORMATION NEEDED TO REACH AN INFORMED DECISION."

PROFESSOR DAVID RATNER RECENTLY PREPARED A MEMORANDUM FOR THE ICI ARGUING THAT THE LINE OF CASES TYPIFIED BY VIRGINIA PHARMACY AND BATES CONSTITUTIONALLY LIMITS THE COMMISSION'S AUTHORITY TO REGULATE MUTUAL FUND ADVERTISING.

ALTHOUGH PROFESSOR RATNER'S ARGUMENT HAS A SUPERFICIAL APPEAL, ITS LOGICAL CONCLUSION IS A HOLDING THAT SECTION 5 OF THE 1933 ACT, AS APPLIED TO INVESTMENT COMPANIES IS UNCONSTITUTIONAL UNDER THE FIRST AMENDMENT. I DOUBT THE SUPREME COURT WOULD SO HOLD. IN EACH OF THE CASES RELIED UPON BY PROFESSOR RATNER, THE EFFECT OF THE STATUTE OR REGULATION INVALIDATED WAS TO LIMIT OR BAR THE INFORMATION WHICH COULD BE PRESENTED TO CONSUMERS, WHILE SECTION 5 REQUIRES EXPANSIVE DISCLOSURE.

NEVERTHELESS, THE RECENT AWARENESS THAT ADVERTISING IS ENTITLED TO SOME CONSTITUTIONAL PROTECTION UNDER THE FIRST AMENDMENT SHOULD INFLUENCE THE COMMISSION'S RULEMAKING. I BELIEVE WE WILL BE SENSITIVE TO THE RULING BY THE SUPREME COURT THAT REGULATION OF ADVERTISING SHOULD BE ACCOMPLISHED, WHERE POSSIBLE, IN THE MANNER THAT LEAST INFRINGES UPON THE RIGHTS OF CONSUMERS TO RECEIVE INFORMATION, WHILE AT THE SAME TIME, WE ATTEMPT TO ACHIEVE OUR LEGITIMATE REGULATORY OBJECTIVE OF PROTECTING INVESTORS FROM MISLEADING INFORMATION IN CONNECTION WITH OFFERINGS OF SECURITIES.

THE COMMISSION IS WILLING TO CONSIDER FULLY AND SERIOUSLY, THE ICI'S PROPOSAL FOR CHANGE IN THE REGULATION OF MUTUAL FUND ADVERTISING. BUT ANY PRESCRIPTIONS FOR REFORM BY SEC RULEMAKING MUST TAKE INTO CONSIDERATION THE LIMITATIONS OF THE EXISTING STATUTORY FRAMEWORK AND THE CONCERN OF THE COMMISSION FOR THE PROTECTION OF INVESTORS -- THE POLICY WHICH UNDERLIES THAT STATUTORY FRAMEWORK.

I AM SURE YOU ARE AS FAMILIAR AS I AM WITH HOW THE COMPLEXITIES OF PROHIBITION AND DEFINITION IN THE SECURITIES ACT OF 1933 IMPACT UPON MUTUAL FUND ADVERTISING. I WOULD LIKE TO REVIEW WITH YOU BRIEFLY THOSE RELEVANT PROVISIONS OF OUR STATUTES TO REMIND YOU THAT WE ARE NOT WRITING ON A CLEAN SLATE. HOWEVER INGENIOUS THE COMMISSION AND ITS STAFF MAY BE, ACHIEVING GREATER ADVERTISING FREEDOM WITHIN THE CONFINES OF SECTION 5 IS AN ELUSIVE ENDEAVOR.

UNDER SECTION 5(A) OF THE SECURITIES ACT OF 1933, A MUTUAL FUND MAY NOT OFFER ANY SHARES TO THE PUBLIC UNLESS IT HAS FILED A REGISTRATION STATEMENT WITH THE COMMISSION, OR SELL ANY SHARES UNLESS THE REGISTRATION STATEMENT HAS BEEN DECLARED EFFECTIVE. THE REGISTRATION STATEMENT OF A MUTUAL FUND MUST CONTAIN SUCH INFORMATION AS IS SPECIFIED IN SECTION 8(B) OF THE INVESTMENT COMPANY ACT. UNDER SECTION 5(B) OF THE SECURITIES ACT A MUTUAL FUND, IN OFFERING OR SELLING ITS SHARES MAY NOT USE ANY PROSPECTUS WHICH DOES NOT CONTAIN ALL THE INFORMATION SPECIFIED IN SECTION 10(A) OF THE ACT.

ALTHOUGH AN ADVERTISEMENT WOULD NOT BE REGARDED AS A "PROSPECTUS" BY A CONSUMER UNTUTORED IN THE SECURITES LAWS, THE DEFINITIONAL SECTIONS OF THE SECURITIES ACT DO SO. SECTION 2(10) DEFINES THE TERM "PROSPECTUS" TO INCLUDE ANY NOTICE, CIRCULAR, ADVERTISEMENT, LETTER OR COMMUNICATION WHICH OFFERS ANY SECURITY FOR SALE.

THEREFORE, UNLESS OTHERWISE EXCEPTED FROM THAT DEFINITION, SUCH COMMUNICATIONS MUST MEET THE REQUIREMENTS OF A SECTION 10(A) STATUTORY PROSPECTUS.

NEVERTHELESS, ABBREVIATED COMMUNICATIONS TO PROSPECTIVE PURCHASERS ARE PERMITTED. SECTION 10(B) OF THE SECURITIES ACT AUTHORIZES THE COMMISSION BY RULE TO ALLOW THE USE OF PROSPECTUSES WHICH SUMMARIZE OR OMIT THE INFORMATION CONTAINED IN A FULL SECTION 10(A) PROSPECTUS. THE TYPE OF COMMUNICATION SPECIFIED IN EXISTING RULE 434A IS A SUMMARY PROSPECTUS. THE TYPE OF COMMUNICATION SUGGESTED IN PROPOSED RULE 434D IS AN OMITTING PROSPECTUS.

SECTION 2(10)(A) OF THE SECURITIES ACT EXCEPTS FROM THE TERM "PROSPECTUS" COMMUNICATIONS WHICH ARE ACCOMPANIED OR PRECEDED BY A FULL SECTION 10(A) PROSPECTUS. HOWEVER, SUCH SALES LITERATURE IS STILL SUBJECT TO THE ANTI-FRAUD PROVISIONS OF THE SECURITIES LAWS. SECTION 2(10)(B), EXCEPTS FROM THE TERM "PROSPECTUS" CERTAIN LIMITED COMMUNICATIONS, COMMONLY KNOWN AS "TOMBSTONE ADS". IN THE CASE OF REGISTERED INVESTMENT COMPANIES, RULE 134 EXPANDS THE TYPE AND AMOUNT OF INFORMATION INCLUDABLE IN TOMBSTONE ADS BEYOND THAT PERMITTED TO OTHER ISSUERS.

YOU ARE WELL AWARE THAT THERE ARE POTENTIAL ADVERSE MONETARY CONSEQUENCES FOR VIOLATIONS OF THE SECURITIES LAWS. IN ADDITION TO IMPLIED RIGHTS OF ACTION UNDER THE ANTI-FRAUD PROVISIONS OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 12(2) OF THE SECURITIES ACT AFFORDS A PRIVATE RIGHT OF ACTION TO INVESTORS WHO HAVE PURCHASED A SECURITY PURSUANT TO A FALSE OR MISLEADING PROSPECTUS OR ORAL COMMUNICATION.

THE STATEMENT OF POLICY WHICH HAS BECOME SUCH AN ANATHEMA TO THE MUTUAL FUND INDUSTRY IS ACTUALLY A SAFE HARBOR FOR THE PREPARATION OF SALES LITERATURE. UNDER SECTION 24(B) OF THE INVESTMENT COMPANY ACT, A MUTUAL FUND IS REQUIRED TO FILE WITH THE COMMISSION COPIES OF ANY ADVERTISEMENT OR OTHER SALE LITERATURE WITHIN 10 DAYS AFTER SUCH LITERATURE IS USED. THE COMMISSION DOES NOT DECLARE THE SALES LITERATURE EFFECTIVE OR OTHERWISE REVIEW IT EXCEPT FOR AFTER THE FACT COMPLIANCE WITH OUR ANTI-FRAUD PROVISIONS.

SINCE 1950, HOWEVER, THE COMMISSION HAS PROMULGATED A STATEMENT OF POLICY ON THE SALES LITERATURE OF MUTUAL FUNDS. IT WAS ISSUED "SO THAT ISSUERS, UNDERWRITERS AND DEALERS MAY UNDERSTAND CERTAIN OF THE TYPES OF ADVERTISING AND SALES LITERATURE WHICH THE COMMISSION CONSIDERS MAY BE VIOLATIVE OF THE STATUTORY STANDARDS". THE STATEMENT OF POLICY CONTAINS TWO TYPES OF GUIDELINES BY EXAMPLE: (1) TYPES OF MATERIALLY MISLEADING STATEMENTS; AND (2) APPROVED CHARTS OR TABLES WHICH ARE NOT MISLEADING.

THE NASD AS PART OF ITS SELF-REGULATORY FUNCTION, ADMINISTERS THE SEC'S STATEMENT OF POLICY AND PROVIDES INTERPRETATIVE ADVICE TO ITS MEMBERS. THROUGH THE USE OF INFORMAL PRE-CLEARANCE PROCEDURES, THE NASD HAS TRANSFORMED THE SEC'S STATEMENT OF POLICY INTO A DISCLOSURE STANDARD FOR NASD MEMBERS. THE COMMISSION WILL NOT ORDINARILY PRE-CLEAR SALES LITERATURE OF MUTUAL FUNDS TO DETERMINE WHETHER SUCH LITERATURE COMPLIES WITH OUR STATEMENT OF POLICY.

IF I CORRECTLY UNDERSTAND THE PROPOSAL MADE TO US BY THE ICI LAST MONTH, THE STATEMENT OF POLICY WOULD BE REPLACED BY AN INDUSTRY DRAFTED CODE OF ADVERTISING REGULATIONS, WHICH WOULD BE SELF-EXECUTING. PURSUANT TO SECTION 2(10)(B) ADVERTISEMENTS WHICH COMPLY WITH THE CODE WOULD BE EXEMPT FROM THE DEFINITION OF "PROSPECTUS". ANY ADVERTISEMENT WHICH DID NOT COMPLY WITH THE CODE WOULD BE AN ILLEGAL PROSPECTUS, AND VIOLATE SECTION 5. PRESENT PROVISIONS OF RULE 134 WHICH PERMITS MUTUAL FUNDS GREATER LATITUDE IN TOMBSTONE ADS THAN OTHER ISSUERS HAVE WOULD PRESUMABLY BE REPEALED. WHETHER ANY SECTION 10(B) PROSPECTUS, AS CONTEMPLATED BY RULE 434A OR PROPOSED RULE 434D WOULD BE UTILIZED IN THE ICI PROPOSAL IS UNCLEAR TO ME.

NOW THAT I HAVE FINALLY FOUND MY WAY THROUGH THAT MAZE OF INTRICATE STATUTORY ANALYSIS, I AM NOT CERTAIN WHETHER THERE ARE ANY OPEN SPACES BEYOND THE HEDGES. I AM REMINDED BY THE PROGNOSTICATION OF BAYLESS MANNING THAT WE ARE SUFFERING FROM TOO MUCH LAW, WHICH HE CALLED "HYPERLEXIS... A FORM OF SOCIAL ILLNESS THAT HAS A LITERALLY FATAL POTENTIAL FOR THE OPERATION OF THE AMERICAN POLITICAL SYSTEM." 33 BUSINESS LAWYER 436 (1977).

HOWEVER, IF YOU ARE STILL WITH ME, I WILL TRY TO TAKE YOU THROUGH THOSE OPTIONS WHICH SEEM TO ME TO BE OPEN TO US.

FIRST, THERE IS THE ALTERNATIVE PRESENTED BY THE ICI'S PROPOSAL WHICH I HAVE BEEN DISCUSSING. WE NEED MORE SPECIFICITY WITH REGARD TO THIS PROPOSAL. I HAVE ALREADY MENTIONED THE NEED TO UNDERSTAND WHAT SHOULD BE THE ROLE OF THE NASD AND THE COMMISSION STAFF, AND WHETHER AND TO WHAT EXTENT THERE SHOULD BE A PRE-CLEARANCE MECHANISM. IN ADDITION, WE NEED TO UNDERSTAND THE ICI'S POSITION WITH REGARD TO THE CIRCUMSTANCES UNDER WHICH FUNDS COULD INCUR LIABILITY TO INVESTORS AS A RESULT OF MISLEADING COMMUNICATIONS TO POTENTIAL PURCHASERS. WOULD NEGLIGENT VIOLATIONS OF THE INDUSTRY ADVERTISING CODE BE ACTIONABLE? IF SO, UNDER WHAT SECTIONS OF THE SECURITIES LAWS? WHAT LEGAL CONSEQUENCES WOULD FLOW AS THE RESULT OF A COMMUNICATION WHICH, WHILE MATERIALLY MISLEADING, DOES NOT VIOLATE ANY PARTICULAR PROVISION OF THE ADVERTISING CODE? WOULD DIRECTORS BE LIABLE FOR DEFECTIVE ADVERTISEMENTS? HOW WOULD COMMUNICATIONS PURSUANT TO THE ADVERTISING CODE INTERFACE WITH A SECTION 10(A) STATUTORY PROSPECTUS?

IN THE EVENT YOU FIND THESE QUESTIONS TOO HARD TO ANSWER, LET US TURN TO A SECOND ALTERNATIVE, -- THE UTILIZATION OF AN OMITTING PROSPECTUS AS PROPOSED BY RULE 434D, EITHER AS IT IS CURRENTLY CONTEMPLATED OR WITH MODIFICATIONS. SOME OF THE PROVISIONS OF THAT PROPOSED RULE HAVE RECEIVED A SIGNIFICANT AMOUNT OF CRITICISM.

I HAVE EVEN LESS RESPONSIBILITY FOR WHAT THE COMMISSION SAID IN PROPOSING RULE 434D THAN THE COMMISSION HAS FOR WHAT I SAY HERE TODAY, AND AS ALL OF YOU KNOW, I MUST DISCLAIM ANY COMMISSION RESPONSIBILITY FOR ANY OF THESE REMARKS. ACCORDINGLY, I WILL ADMIT TO MY PERSONAL OPINION THAT SOME OF THE CRITICAL COMMENT OF RULE 434D IS JUSTIFIED. THE RULE'S FAILURE TO PERMIT THE USE OF RADIO AND TELEVISION ADVERTISEMENTS SHOULD BE RECONSIDERED. I AM DUBIOUS ABOUT THE WISDOM OF THE 600 WORD LIMITATION. ON THE OTHER HAND, THE LIMITATION OF USE OF ADVERTISEMENTS UNDER THE RULE IN DIRECT MAILINGS SEEMS VALID. THE VERY PURPOSE OF THE RULE WOULD BE TO PERMIT ADVERTISING IN A SITUATION IN WHICH THE USE OF A FULL PROSPECTUS IS NOT FEASIBLE. SUCH A SITUATION EXISTS IN THE CASE OF NEWSPAPER ADVERTISEMENT, WHERE IT IS NOT POSSIBLE TO SEND A FULL PROSPECTUS TO ALL SUBSCRIBERS OR PURCHASERS OF THE NEWSPAPER AND NOT ECONOMICAL TO PUBLISH A FULL PROSPECTUS IN THE NEWSPAPER ITSELF. IN A DIRECT MAILING, SALES LITERATURE IS ALREADY ALLOWED, WHEN ACCOMPANIED OR PRECEDED BY A FULL STATUTORY PROSPECTUS.

A THIRD ALTERNATIVE AVAILABLE TO THE COMMISSION IS TO REVISE RULE 134 TO PROVIDE THAT MUTUAL FUNDS MAY USE ANY INFORMATION IN THEIR ADVERTISEMENTS WHICH IS NOT MATERIALLY FALSE OR MISLEADING. ADS WHICH ARE NOT FALSE OR MISLEADING WOULD BE EXCEPTED FROM THE DEFINITION OF A PROSPECTUS FOR ALL PURPOSES, WHILE MISLEADING ADS WOULD REMAIN PROSPECTUSES FOR THE PURPOSES OF CIVIL LIABILITY UNDER SECTION 12(2). OF COURSE, THE GENERAL ANTI-FRAUD PROVISIONS WOULD ALSO APPLY.

IF FUNDS WANTED TO USE SIMPLE TOMBSTONE ADS SUCH AS THOSE PERMITTED FOR OPERATING COMPANIES, THEN SUCH ADS COULD STILL BE EXCEPTED FROM THE TERM "PROSPECTUS" FOR ALL PURPOSES. WHILE THIS ALTERNATIVE SOUNDS MUCH LIKE THE ICI'S PROPOSAL, IT IS MORE RADICAL. THE STATEMENT OF POLICY WOULD BE RESCINDED AND IT WOULD NOT BE REPLACED BY ANY NEW SAFE HARBORS, SUCH AS AN INDUSTRY ADVERTISING CODE. EACH FUND WOULD HAVE TO DETERMINE FOR ITSELF WHETHER ITS ADVERTISEMENTS ARE TRUTHFUL OR DECEPTIVE, AND THEN BE WILLING TO DEFEND THAT DETERMINATION IN ANY LITIGATION WHICH MIGHT QUESTION IT.

A FOURTH POSSIBLE ALTERNATIVE IS LEGISLATIVE CHANGE, WHICH MAY BE REQUIRED TO ACHIEVE YOUR OBJECTIVES. SUCH LEGISLATION COULD AMEND THE SECURITIES ACT, PROVIDE EXEMPTIONS TO SECTIONS 2(10) AND 5 FOR MUTUAL FUND ADVERTISING AND SALES, AND SUBJECT THEM TO SOME ALTERNATIVE DISCLOSURE SCHEME. ALTHOUGH I HAVE NO SPECIFIC IDEAS ABOUT THE FORM OR SUBSTANCE OF SUCH LEGISLATION TO GIVE YOU TODAY, IT IS AN ALTERNATIVE WHICH IS WORTH YOUR CONSIDERATION.

THE FINAL ALTERNATIVE WHICH I WILL MENTION IS TO RETAIN THE STATUS QUO. COMMENTS ON PROPOSED RULE 434D AND THE ICI'S RECENT PRESENTATION INDICATE THAT ADVERTISING UNDER THE EXISTING TOMBSTONE RULE, AS EXPANDED, IS EXTENSIVE. FEAR WAS EVEN EXPRESSED THAT ADOPTION OF RULE 434D MIGHT LEAD TO MORE RESTRICTIVE INTERPRETATIONS OF WHAT IS PERMITTED BY RULE 134. ARE YOUR SALES ACTIVITIES REALLY HAMPERED BY RULE 134 IN ITS PRESENT FORM, OR BY ECONOMIC CONDITIONS?

TO THE EXTENT THAT EXPANSION OF THE SCOPE OF ADVERTISING WILL BE ACCOMPANIED BY A CORRESPONDING EXPANSION OF POSSIBLE LIABILITY, SOME OF THE INDUSTRY MIGHT PREFER THE RELATIVE SAFETY OF EXISTING REGULATION.

MY PERSONAL INCLINATION, ALTHOUGH I AM OPEN TO CONTRARY PERSUASION, IS THAT MUTUAL FUNDS SHOULD BE ALLOWED FREE EXPRESSION IN THEIR ADVERTISEMENTS AND SALES LITERATURE BUT, BE LIABLE TO INVESTORS IN THE EVENT THAT THEIR COMMUNICATIONS ARE MISLEADING. IN ANY EVENT, I WHOLE-HEARTEDLY CONCUR WITH YOUR POSITION THAT ANY REGULATORY CHANGES SHOULD SERVE TO SIMPLIFY RATHER THAN TO COMPLICATE FURTHER THE EXISTING SCHEME, BOTH FROM THE POINT OF VIEW OF THE INDUSTRY AND THE COMMISSION'S STAFF.

IT IS OFTEN REMARKED THAT IT TAKES MORE TIME TO WRITE A SHORT MEMORANDUM THAN A LONG ONE. SIMILARLY IT IS HARDER AND MORE TIME CONSUMING TO EFFECTIVELY REGULATE WITH SIMPLE RATHER THAN COMPLEX LAWS. IT WOULD PLEASE ME GREATLY TO DISCOVER THAT THE INDUSTRY AND THE COMMISSION HAVE THE WILL AND THE SKILL TO DE-REGULATE INVESTMENT COMPANIES, WITH RESPECT TO ADVERTISING RESTRICTIONS AND MANY OTHER MATTERS.

YOU MUST DECIDE, HOWEVER, THAT YOU ARE WILLING TO PAY THE PRICE FOR FREEDOM FROM GOVERNMENT INTERFERENCE IN YOUR BUSINESS DECISIONS. YOU MUST BE READY TO ACCEPT THE GREATER RESPONSIBILITY AND POSSIBLE LIABILITY WHICH DE-REGULATION WOULD BRING.

NEITHER THE GOVERNMENT NOR THE INDUSTRY ARE IN A POSITION TO TOLERATE DECREASED INVESTOR PROTECTION OR CONFIDENCE UNDER THE GUISE OF REFORM.