ACTION MEMORANDUM

112-28 [redacted]

APR 29

TO: The Commission

FROM: The Division of Investment Management

RE: Advertising by Investment Companies

NOVEL, UNIQUE OR COMPLEX ISSUES: Is there a need to liberalize the rules regulating investment company advertising? If so, can this be done in a manner that is consistent with the 1933 Act?

RECOMMENDATION: 1) That a rule be proposed for public comment under which any investment company registered under the Investment Company Act of 1940 ("1940 Act") which has filed a registration statement under the Securities Act of 1933 ("1933 Act") would be permitted to advertise with respect to the securities referred to in such registration statement 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 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, excepting 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) That Rule 134 be amended to remove the restriction limiting the use of expanded tombstone advertisements to investment companies whose registration statements under the 1933 Act have become effective.

OTHER DIVISIONS OR OFFICES CONSULTED: Division of Corporation Finance, Division of Enforcement, Office of the General Counsel and Office of Consumer Affairs

VIEWS OF OTHER DIVISIONS OR OFFICES CONSULTED: The Division of Corporation Finance has no objections, the Office of General Counsel concurs with the memorandum, the Office of Consumer Affairs expressed some concern about the proper format for inclusion of performance data in investment company advertising and the potential misleading effect thereof, and the Division of Enforcement will submit a separate memorandum.

ACTION REQUESTED BY: Normal Schedule

STAFF MEMBER TO CONTACT: Stanley B. Judd
755-0213

257-14

DISCUSSION

I. Background.

(A) The general statutory plan of regulation.

Investment companies, like other issuers, are restricted in their opportunities to advertise by the following: (1) Section 2(3) of the 1933 Act which defines an "offer to sell" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or an interest in a security, for value; (2) Subsection (c) of Section 5 of the 1933 Act which makes it unlawful for any person to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security unless a registration statement has been filed as to such security; (3) Section 2(10) of the 1933 Act which includes an advertisement, written or by radio or television, in the definition of a prospectus; and (4) Section 5(b)(1) of the 1933 Act which prohibits the use of jurisdictional means to carry or transmit any prospectus relating to any security with respect to which a registration statement under the 1933 Act has been filed unless such prospectus meets the requirements of Section 10 of the 1933 Act. Under Section 10(a) of the 1933 Act, prospectuses are required to contain, with certain exceptions, information which Section 7 of the 1933 Act, and Schedules A and B thereunder, require to be included in a registration statement.

(B) Exceptions to the general rule.

There are three exceptions to the general requirement that written or radio or television communications offering securities for sale be in the form of Section 10(a) prospectuses. Two of these are provided by means of exceptions from the definition of a prospectus and the third is for a prospectus which omits in part or summarizes information in the Section 10(a) prospectus.

(1) Section 2(10)(a) excepts from the definition of a prospectus, a communication preceded or accompanied by a written prospectus meeting the requirements of Section 10(a).

It is under this exemption that investment companies have sent to investors sales literature together with a Section 10(a) prospectus.

(2) Section 2(10)(b) excepts from the definition of a prospectus,

> "a notice, circular, advertisement, letter or communication ~~in respect~~ of a security . . . [which] states from whom a written prospectus meeting the requirement of section 10 may be obtained and, in addition, 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 or 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."

This second exception, and Rule 134 thereunder, permits the so-called "tombstone" advertisement.

(3) The third exception from the general scheme of regulation is provided by Section 10(b) which authorizes the Commission by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors to permit the use of a prospectus, for the purpose of subsection (b)(1) of Section 5, which omits in part or summarizes information in the prospectus specified in Section 10(a).

(C) The problems of investment companies under the general scheme of regulation which restricts written or radio or television communications offering a security for sale to the Section 10(a) prospectus.

Investment companies have contended that the general scheme of regulation has a particularly adverse effect upon them for three reasons.

First, unlike other companies, their only product is their shares. If they can't advertise their shares, they can't advertise the company. In other words, 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 can not 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 they will be ignorant of it and uninterested in it.

Third, institutions such as savings and loan institutions and insurance companies, which compete with investment companies for investor interest, especially investor interest in Keogh Plans and IRAs, are not subject to the same limitations on their advertising as are investment companies. Therefore, investment companies claim that under the general scheme of regulation they are hindered in their attempts to compete with banks and insurance companies for investor interest.

(D) The Commission's response.

Believing that there is a general lack of knowledge by investors as to the nature of investment companies, and in recognition of the fact that such companies are subject to comprehensive regulation under the 1940 Act, the Commission has, since 1972, gradually liberalized the advertising restrictions under which registered investment companies operate.

These changes have been effected by expanding the specific information permitted in an advertisement under Rule 134 adopted pursuant to Section 2(10) of the 1933 Act. Advertisements under the rule, because they were traditionally brief and basic with lots of surrounding white space, have been called "tombstone advertisements".

Prior to 1972, Rule 134, the "tombstone rule", 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 subclassification under the Act, i.e., whether it was a face amount certificate company, unit investment trust or management company and, if the latter, whether it was an open-end or closed-end company and whether it was diversified or non-diversified, (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. The Commission also announced that henceforth it would not object in tombstone advertising for investment company securities to the use of advertising designs and devices including borders, scrolls, arrows, pointers, multiple and combined logos and unusual typeforms and lettering. It was also announced that when the medium of television was used, such advertising could use moving logos and other designs and devices permitted by this rule.

In 1974, the rule was further amended to permit identification of the company's investment adviser, any logo, corporate symbol or trademark of the company or its investment adviser, and any graphic design or device or an attention-getting headline, not involving performance figures, designed to direct the reader's attention to textual material included in the communication pursuant to other provisions of the rule and, with respect to an open-end investment company whose registration statement under the 1933 Act is effective and whose securities are the subject of a continuous offering pursuant to such registration statement, (i) a description of such company's investment objectives and policies, services and method of operation; (ii) identification of the company's principal officers; (iii) the year of incorporation or organization or period of existence of the company, its investment adviser or both; (iv) the company's aggregate net asset value as of the most recent practicable date; (v) the aggregate net asset value as of the most recent practicable date of all registered investment companies under the management of the company's investment adviser;and (vi) any pictorial illustration contained in the company's prospectus and not involving performance figures; provided that if any material permitted by clauses (i) through (vi) is included, such communication shall also contain the following legend in 12 point boldface type: "For more complete information about (Name of Company), including sales charges, management fees, and/or expenses, see our prospectus. It is important to read the prospectus carefully before you decide to invest. A copy of the prospectus may be obtained from your securities dealer or by writing to (Distributor's Address). Send no money"; or (2) a coupon which the reader may mail to receive a prospectus, with the following legend in 12 point boldface type: "For more complete information about (Name of Company) including sales charges, management fees and other expenses, mail this coupon and we will send you our prospectus. It is important to read the prospectus carefully before you decide to invest. Send no money."

In 1975, the rule was amended again to make the use of the expanded investment company advertisement permissible for any investment company issuing redeemable securities whose registration statement under the 1933 Act is effective, to shorten the legend and require only that it be set in a size type at least as large as, and of a style different from, but at least as prominent as, that used in the major portion of the advertisement, and also to permit descriptive material relating to economic conditions, or to retirement plans or other goals to which an investment in the company could be directed, but not directly or indirectly relating to past performance or implying achievement of investment objectives and to any pictorial illustration which would be appropriate for inclusion in the company's prospectus and not involving performance figures.

The Commission also has promulgated a rule, Rule 135(a), which provides that an advertisement which is about investment companies but does not specifically refer i.e., by name, to any particular investment company; so-called generic advertisement, and which is limited to certain information, will not, for purposes of Section 5 of the 1933 Act, be deemed to offer any security for sale. In some respect, the information permitted about investment companies in a generic advertisement is broader than the information permitted in a Rule 134 advertisement.

(E) The operation of the expanded tombstone rule.

Certain questions have arisen under the expanded tombstone rule and the industry is still, in some ways, unsatisfied with it.

One question is how to determine when an advertisement contains only "a brief indication of the general type of business of the issuer" (Rule 134(a)(3)), which indication would not necessite the legend, and when does an advertisement contain a description of a company's investment objectives, and policies, services, and method of operation which would require the legend. The problem is complicated by the fact that since the information that would require the legend can be provided only by a company whose registration statement under the 1933 Act has become effective, a company without an effective registration statement cannot include such information in its pre-effective advertising. Prior to the amendment, some pre-effective investment company advertising apparently included information that might now be considered as requiring the legend. The present rule, therefore, precludes such information from being in a pre-effective advertisement even if the legend is included.

Another related question is what is a "brief" indication or, put another way, when does an advertisement because of its length cease to qualify under Rule 134?

In addition to these continuing questions, it has been found desirable, in some regards, to interpret the expanded rule as incorporating pre-expansion practice, such as the inclusion in a Rule 134 advertisement (without the legend) of the statement, where appropriate, that a fund charges no sales load.

It has also been suggested that because of the tremendous cost of radio or TV time, the legend requirements, which take time to present effectively, preclude the use of spot advertisements on radio and television and, therefore, foreclose these media to investment companies.

In addition, since funds, even under the expanded rule, cannot give performance data, it is argued that they are still at a disadvantage in competing with insurance companies and banks.

We have also had indications from the NASD that the expanded rule has created a number of problems of interpretation because the greater the number of specific kinds of information permitted, the greater the number of questions about whether the information contained in any specific advertisement comes within or falls without the permitted categories.

II. The desirability of permitting greater freedom in advertising.

One reason for permitting greater freedom in advertising is that the existing rules as applied to any particular case may produce an arbitrary result. For example, Rule 134 permits an advertisement to state the net aggregate net asset value as of the most recent practicable date of all registered investment companies under the management of the company's investment adviser. Since it does not permit the advertisement to state the aggregate net asset value of all accounts under the management of the company's investment adviser, an advertisement which stated, for example, that the adviser of a company investing in municipal bonds was also the adviser with respect to accounts (non-investment company) holding 2 billion dollars worth of municipal bonds, would not be within Rule 134 and would, as a result, be an illegal prospectus. Nevertheless it could be argued that such information may be more relevant to prospective investors in the company than the amount of investment company assets i.e., municipal bond funds or otherwise, under management of the adviser.

To correct these problems as they occur would require that Rule 134 be in a continuous state of amendment.

Another reason for permitting greater freedom in investment company advertising is that to the extent that investors have more information available to them, they will make better decisions. 1/

1/ Cf. Virginia State Board of Pharmacy et al. v. Virginia Citizens Consumer Council, 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."

A third reason for permitting greater freedom in advertising, is that it may serve to reduce the role of salesmen in the sale of investment company shares and, thus, tend to the reduction of sales expenses. A corollary to this is that greater freedom in advertising may cause presentations that are now private to come out in the open where they would be subject to public scrutiny and comment.

III. The legislative authority for expanding investment company advertising.

(A) Section 2(10)(b) presents a dubious basis for any further significant expansion of investment company advertising.

Section 2(10)(b) was designed to afford merely a device for screening out those prospective customers who might be sufficiently interested in the particular security to ask for a statutory prospectus. 2/

Prior to amendment in 1954, the section permitted a tombstone advertisement to contain only a statement of from whom a statutory prospectus may be obtained and to identify the security, state the price thereof and state by whom orders would be executed.

The purpose of this limitation was to avoid the inclusion in such advertisements of misleading and insufficient statements. 3/

In 1954, the section was amended by the addition of a clause permitting a tombstone advertisement to include also "such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be presented therein, may permit."

The rule-making power was inserted in 1954 in view of "the wide variations in the types of issues, securities, and offerings subject to the Securities Act" and was designed "to permit appropriate variation in the contents of such advertisement under such safeguards as may be necessary in the circumstances. 4/

2/ 1 Loss, "Securities Regulation" 227 (2d ed. 1961).

3/ H.R. Rep. No. 85, 73d Cong. 1st Sess. (1933) 13.

4/ 1 Loss, "Securities Regulation" 208 (2d ed. 1961) citing S. Rep. No. 1036 at 13 and H.R. Rep. No. 1542 at 22, 83d Cong. 2d Sess. (1954).

The purpose of the 1954 Amendment seems to have been to enable the Commission to permit the inclusion in a tombstone advertisement of items of information that were of the same class or general nature as those specifically enumerated. 5/

There is no indication that the 1954 amendment was intended to contravene the original intention of the Congress to limit tombstone advertisements to information not likely to lead to "the inclusion in such advertisements of misleading and insufficient statements." 6/

Furthermore, since under Section 12(2) of the 1933 Act 7/ only an untruthful or misleading prospectus or oral communication can give rise to an action for rescission under that section, it would be contrary to the purpose of the 1933 Act to construe Section 2(10)(b) as permitting a written communication that is excepted from the definition of a prospectus to include items of information that might lead to the inclusion of misleading and insufficient statements.

5/ "Where general words follow the designation of particular things or classes of persons or subjects, the general words will usually be construed to include only those persons or things of the same class or general nature as those specifically enumerated." Crawford, "The Construction of Statutes" para. 190 at 326 (1940).

6/ Footnote 3 supra.

7/ Section 12(2) of the 1933 Act makes any person who offers or sells a security by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statement, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission, liable to the person purchasing such security from him for the cost of the security plus interest less any income received upon the tender of the security, or for damages if he no longer owns the security.

Tombstone advertisements, therefore, are probably limited to information which carries little risk of being misleading or insufficient. 8/ Since information concerning performance, which Rule 134 specifically prohibits, and which the investment company industry would like to be able to provide prospective investors, is information that may, in the absence of appropriate disclosure, be misleading, 9/ it seems appropriate that such information not be permitted in a tombstone advertisement.

It appears, therefore, that the present provisions of Rule 134 on the information that can be included in a "tombstone" advertisement about an investment company may have reached the limits of what is permissible in a communication that is not a prospectus.

(B) Authority for expanding investment company advertising can, however, be found under Section 10(b).

(1) The provisions of Section 10(b).

As has been stated, Section 10(b) of the 1933 Act provides that in addition to the prospectus permitted or required in Section 10(a), the Commission shall by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors permit the use of a prospectus for the purposes of Section 5(b)(1) (transmission in interstate commerce or by jurisdictional means of any prospectus relating to a security with respect to which a registration statement has been filed) which omits in part or summarizes information in the prospectus specified in Section 10(a).

8/ In proposing the adoption of Rule 134 in 1955, the Commission emphasized "that such communications [advertisements pursuant to the rule] are intended to be limited to announcements identifying the existence of a public offering and the availability of a prospectus and they are not to be selling literature of any kind" Sec. Act Rel. No. 3535 (1955).

9/ Used as sales literature; i.e., as material directed to interest an investor in investing in an investment company, information about the past experience or "performance" of the company may carry the implication or give rise to the inference that the information indicates the quality of the investment advice that was given and which the prospective investor may expect. This information may be misleading in the absence of other information about the general trend in the market during the period in question and the level of risk assumed by the fund in comparison with the risk of the market. Moreover, there is a chance that, to the prospective investor, the implied or inferred relevance of such information is that it indicates how well he might do if he invested in the company. Information containing such an implication or leading to such an inference would be especially misleading if the information presented covered a selected period or periods during which the market was in a specific phase or was unusual in comparison to its historical and/or most recent performances and such facts were not also disclosed.

(2) Investment Company advertising under the present "summary" prospectus rule is not practical.

Pursuant to Section 10(b), the Commission adopted Rule 434, with respect to prospectuses prepared by independent organizations, and Rule 43[illegible]-a, 10/ the so-called "summary prospectus" rule. This latter rule provides that a summary prospectus prepared and filed as part of a registration statement in accordance with the provisions of the rule shall be deemed to be a prospectus permitted under Section 10(b) of the Act for the purpose of Section 5(b)(1) of the Act, if the form used for registration of the securities to be offered provides for the use of a summary prospectus.

A summary prospectus is required to contain the information specified in the instructions as to summary prospectuses in the form used for registration of the securities to be offered and may include any other information the substance of which is contained in the registration statement except as otherwise specifically provided in such form. It may not include any information the substance of which is not contained in the registration statement except that a summary prospectus may contain any information specified in Rule 134(a).

10/ Rule 434a was modeled on and replaced two of the so-called "newspaper prospectus" rules. These two rules were contained, respectively in Form S-1, the basic registration form, and Form S-9, the special form for institutional type debt securities. 1. Loss, "Securities Regulation" at 237, 249 (2d ed. 1961) A third rule still survives in the form of Rule 494 which relates only to securities issued by a foreign national government. However, Rule 434a is not, as were the replaced rules, and as is Rule 494, limited to advertisements in newspapers of general circulation not distributed by the advertiser and not including reprints, reproductions or detached copies of such advertisements.

"Summary Prospectus", although modeled on the so-called "newspaper prospectus rules", 13/ may be too lengthy, by reason of the requirements of Rule 434a, to serve as an advertisement in public media such as newspapers and magazines of general circulation and on radio and television. Other plausible explanations for the fact that only a few summary prospectuses have been filed are the following (1) the use of a Section 10(a) prospectus is still necessary in the sales process since Section 5(b)(2) of the 1933 Act makes the sending of a security for sale or delivery after sale, by means of the mails or interstate commerce, unlawful unless the security is accompanied or preceded by a Section 10(a) prospectus, and (2) to enable sales literature to be sent it is necessary that a Section 10(a) prospectus also be sent since sales literature accompanied or preceded by a summary prospectus, unlike sales literature accompanied or preceded by a Section 10(a) prospectus, would not be excepted from the definition of a prospectus contained in Section 2(10) of the 1933 Act.

(3) Investment company advertising in public media is a special case that could justify a special rule under Section 10(b).

While the requirements of Rule 434a seem appropriate with respect to a document, such as a summary prospectus, which an investor might confuse with a Section 10(a) prospectus, we question whether they are necessary or appropriate with respect to a brief advertisement in a newspaper or magazine of general circulation or on radio or television.

Pursuant to Section 10(d) of the 1933 Act, the Commission is authorized, in the exercise of its powers under subsection (a), (b), and (c) of Section 10, to classify prospectuses according to the nature and circumstances of their use or the nature of the security, issue, issuer, or otherwise, and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and contents which it may find appropriate and consistent with the public interest and the protection of investors.

There is reason to single out the prospectuses of investment companies for special treatment because, as has been stated, investment companies have special problems under the pattern of regulation under the 1933 Act which, generally, prohibits written advertisements or advertisements on radio or television other than the statutory prospectus.

Advertisements in public media are also a special form of communication. First, the expense of such advertisements puts practical limits to their length so that they are unlikely to be regarded as the equivalent to and an adequate substitute for the statutory prospectus. Second, the context and the form of public advertisements usually distinguish them from statutory prospectuses.

13/ Footnote 10 supra.

Third, public communications are addressed only to the public -- and they are open to public scrutiny.

It seems, therefore, that a rule could be promulgated pursuant to Section 10(b) and 10(d) of the 1933 Act that would permit an investment company advertisement, which is (1) in a newspaper or magazine of general circulation or on radio or television and (2) restricted to information contained in a Section 10(a) prospectus, to serve as a legal prospectus for purposes of Section 5(b)(1).

IV. Limitations and conditions which should be included in a rule under Section 10(b).

(A) The rule should be limited to advertisements by investment companies in public media.

We have already mentioned those factors which make investment company advertising a special case that might justify special treatment. We have also mentioned the characteristics of advertisements in public media that could justify treating them differently from other forms of communication. In addition, the practical considerations that may limit the use of summary prospectuses, as permitted by the present rule, in public media may not be applicable to their use in private communications. Thus, there seems to be little reason at this time for permitting a new form of "private" written communication that would supplant the summary prospectus as presently permitted. For these reasons, a rule under Section 10(b) permitting an advertisement to contain any information included in a Section 10(a) prospectus should be limited to investment company advertisements in public media. The proposed rule, like the present newspaper prospectus rule; i.e., Rule 494, should not apply to reprints, reproductions, or detached copies of a permitted advertisement.

(B) The advertisement must be limited to information the substance of which is contained in the section 10(a) prospectus.

Section 10(b) permits the Commission only to authorize the use of a prospectus for the purpose of subsection (b)(1) of Section 5 which omits in part or summarizes information in the prospectus specified in Section 10(a). Therefore, any information in an advertisement permitted under Section 10(b) must be limited to information which is in the prospectus specified in Section 10(a).

The statute does not require, however, that the words used in an advertisement to convey an idea be the exact words that are used in the prospectus to convey the same idea. Nor does the statute prohibit the use of visual or audio advertising techniques in an advertisement to convey information contained in the statutory prospectus even though such techniques are not themselves part of the statutory prospectus.

Thus, a new rule under Section 10(b) may permit an advertisement to contain, as the present Rule 434(a) permits a summary prospectus to contain, information "the substance of which is contained" in the Section 10(a) prospectus. Such a rule would, for the first time, permit information on performance to be included in an advertisement so long as the substance of the information was also included in the Section 10(a) prospectus. In the absence of agreed standards as to what constitutes performance and how it should be determined, this may be a cause of some concern. However, if statements on performance are included in Section 10(a) prospectuses so that they may be included in advertisements, our review of such prospectuses, for the purpose of determining whether they should be made effective, may lead to the gradual development of more uniform bases for determining performance. Furthermore, statements of performance in any advertisement would be subject to the Statement of Policy on what constitutes materially misleading information.

(C). In order to maintain the statutory prospectus as the primary selling document, any advertisement permitted by a new rule under Section 10(b) should be required to be limited in length and to include a statement of from whom a statutory prospectus may be obtained and the importance of reading that prospectus before investing.

(1) An advertisement should be brief.

In order to preserve the statutory prospectus as the primary selling document, it is necessary that the length of advertisements be limited. Otherwise, they might tend to cause investors to regard the statutory prospectus as superfluous. While they should not be so long as to cause this to happen, they should be long enough to provide whatever information is necessary to prevent the information that is contained from being misleading.

Consideration was given to whether restricting permissible advertisements to public media would place a practical limitation on length that would make specific limitation on length unnecessary. Since an investment company had, for several years, printed a complete statutory prospectus as a Sunday supplement in a newspaper, it appeared that a restriction on the media that may be used would not necessarily limit the length of a communication.

We considered whether it would be sufficient to require that an advertisement under a new rule, like an advertisement under Rule 134, be brief. While there is merit in this approach, for it permits flexibility, we think that there are serious objections to it. First, even though Rule 134 permits advertisements which contain only particular classes of information, questions have arisen as to whether

advertisements purportedly under Rule 134 satisfy the requirement of the rule that they be brief. Questions concerning the meaning of the word "brief" would be even more likely under a rule which would permit any information in the registration statement to be included in an advertisement. Second, there will probably be so many questions of interpretation under a new rule that if an area can be made subject to objective, definite criteria it would probably be in the public interest to do so. Third, a rule should be precise enough to provide guidance and, thus, justify enforcement. For these reasons we believe that a new rule should contain precise limits on length.

One possible limit is the number of words contained in an advertisement. This kind of a limit may be less pertinent to television advertisements than it is to newspaper, magazine or radio advertisements. This is because a television advertisement is likely to be less wordy than an advertisement in these other media. Nevertheless, since it is conceivable, although, perhaps, not probable, that a television advertisement would exceed any word limit applicable to other media, we do not think television advertisements should be excepted from the general restriction on the number of words that can be used. Nor do we think that a special rule limiting the length of television commercials in terms of time is necessary. Economic considerations should prove to be an effective regulator of this factor.

In determining the word limit that should be permitted, we considered a limit that would not be so long as might cause investors to regard a statutory prospectus as superfluous and yet be long enough to permit any information to be stated that would be necessary to prevent other information stated from being misleading. We also considered the length of randomly selected advertisements on the financial pages of newspapers and magazines. These considerations lead us to propose a word limit of 600 words, excluding required legends, and charts and graphs.

We considered whether it would not be sufficient to limit a permitted advertisement to "about" 600 words, but have decided that while such a requirements would provide a degree of flexibility, it would lead to interpretative questions and probably result in some other absolute figure such as 650 or 699 becoming the limit.

To deal with questions that may arise as to what constitutes a "word" for purposes of the 600 word limitation or even what constitutes one advertisement for the purpose of such limitation, it would be desirable for a rule under Section 10(b) to provide (1) that a word, for purposes of the rule shall include any abbreviation, contraction or other shortened representation of a word, (2) a number consisting of one or more digits shall be counted as one word, (3) words joined by a hyphen shall be counted as separate words, and (4) advertisements presented in a manner likely to cause their contents to be integrated cumulatively shall be considered as one advertisement, but television or radio commercials spaced more than one-half hour apart, or on different stations or channels, or advertisements in separate publications shall not be considered as one advertisement.

If, for example, two different advertisements for the same investment company appeared on the same page or successive pages of a newspaper, they would be regarded as one advertisement for purposes of the rule limiting the number of words that may be contained in an advertisement; but if they were identical advertisements they would be regarded as separate advertisements for purposes of the rule.

(2) The advertisement should state from whom a Section 10(a) prospectus containing more complete information may be obtained and that an investor should read that prospectus carefully before investing.

The 1933 Act intended the statutory prospectus to be the primary selling document. Nevertheless, an investor can purchase a security which he learns about from an advertisement or a salesman before receiving a statutory prospectus. Therefore, to preserve the statutory prospectus as the primary selling document while liberalizing what may be included in advertising, it is necessary that the advertising itself state from whom a Section 10(a) prospectus may be obtained, that such prospectus contains more complete information than is contained in the advertisement, and that an investor should read the statutory prospectus carefully before investing.

We think that it would be sufficient to require that this statement be "conspicuous" and that it is not necessary to specify size, type face, etc.

(D) If used prior to the effective date of a registration statement, an advertisement should carry the legend required by Rule 433(b) but should not be required to carry the legend required in all prospectuses by Rule 425.

If an advertisement is used prior to effectiveness of a registration statement (but after the registration statement has been filed), it seems necessary, in order to prevent certain problems from arising, that the advertisement contain the statement required by Rule 433(b) under the 1933 Act. 14/ However, we do not think it necessary that advertisements under the rule also carry the legend required in all prospectuses by Rule 425. 15/

(E) An advertisement made pursuant to a rule under Section 10(b) should not be required to be filed as part of a registration statement, but it should be required to be filed with the Commission shortly after use.

14/ Footnote 11 supra.

15/ Footnote 12 supra.

Section 10(b) provides that a prospectus permitted thereunder shall, except to the extent the Commission by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors otherwise provides, be filed as part of the registration statement but shall not be deemed a part of such registration statement for the purposes of Section 11. 16/

If an advertisement is required to be filed as part of a registration statement, it seems that it should be filed as an amendment to the registration statement. If the registration statement had already become effective, it would be a post-effective amendment to the registration statement.

Section 8(c) of the 1933 Act provides as follows:

> "An amendment filed after the effective date of the registration statement, if such amendment, upon its face, appears to the Commission not to be incomplete or inaccurate in any material respect, shall become effective on such date as the Commission may determine, having due regard to the public interest and the protection of investors."

Thus, the effect of the requirement that advertisements be filed as part of the registration statement would be to require pre-clearance by the staff of any advertisement made pursuant to the rule. This would not only cast the staff in the role of pre-censor of advertising, a role we do not seek, but would also make inordinate demands on the time of the staff conceivably equaling or even surpassing that required to be given to the review of regular registration statements. Therefore, the Commission should except advertisements made pursuant to a rule under Section 10(b) from the requirement that they be filed as part of a registration statement.

However, it would be salutary for the Commission to require any advertisement made pursuant to a rule under Section 10(b) to be filed with the Commission not later than shortly after first use, such as during the first day the Commission is open for business following such use, so that the staff can monitor such use. This would enable the Commission effectively to exercise the power given to it by Section 10(b) to prevent or suspend the use of an advertisement pursuant to a rule under the section if it has reason to believe that the advertisement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which such advertisement is, or is to be, used, not misleading. It would, we believe, provide

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16/ Under Section 11 directors, professionals, underwriters etc. may be liable to purchasers of securities in case a part of a registration statement for which they are responsible, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements made therein not misleading.

satisfactory protection of the interest of investors. We are, after all, dealing only with advertisements, not poisonous substances, and, then, only advertisements limited to information the substance of which must be included in a Section 10(a) prospectus. Thus, while an advertisement itself would not, unless the Commission provides otherwise, be a basis for liability under Section 11 of the 1933 Act, the substance of any information in the advertisement would have to be in the registration statement which is subject to Section 11 when it become effective. The substance of any information included in an advertisement would, therefore, be information with respect to which directors, accountants, underwriters, etc. might be liable to investors if it was false or misleading and if it was contained in the registration statement upon its effectiveness.

We also think it would be desirable for a rule under Section 10(b) to state the person who would be responsible for filing with the Commission an advertisement made pursuant to the rule. That person should be the investment company concerned because it is in the best position to know whether an advertisement about the company is misleading and because the company may be liable if the advertisement is misleading. The company could, of course, delegate the task of filing the advertisement to another person such as its underwriter. However, the placement of an advertisement without its being filed with the Commission within a certain number of days by the investment company or its agent would not be in conformity with the rule.

Filings under the rule should be accepted as satisfying the requirement of Section 24(b) of the 1940 Act which makes it unlawful for certain investment companies; i.e., open-end companies, unit investment trusts, and face amount certificate companies, or their underwriters, in connection with a public offering of any security of which such a company is the issuer, to make use of the media or other instrumentality of interstate commerce to transmit sales literature addressed to or intended for distribution to prospective investors unless three copies have been filed with the Commission or are filed with the Commission within ten days thereafter. In other words duplicate filings should not be required.

V. Any advertisement made pursuant to a rule under Section 10(b) would be subject to those provisions in the securities laws and the rules thereunder which deal with false or misleading statements.

17/ Section 10(f) of the 1933 Act provides that in any case where a prospectus consists of a radio or television broadcast, copies thereof shall be filed with the Commission under such rules and regulations as it shall prescribe, and further provides that the Commission may by rules and regulations require the filing with it of forms and prospectuses used in connection with the offer or sale of securities under the 1933 Act.

Any advertisement made pursuant to a rule under Section 10(b) would not be excepted from the definition of a prospectus. It could, therefore, serve as a basis for rescission or damages under Section 12(2) of the 1933 Act if it contained a materially untrue statement or omitted to state a material fact necessary to make the statements made, in the light of the circumstances in which they were made, not misleading. It might also serve as a basis for action under Section 17(a) of the 1933 Act or Rule 10b-5 under the Securities Exchange Act of 1934.

Section 17(a) of the 1933 Act makes it unlawful, in the offer or sale of a security by jurisdictional means to, among other things, obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. 18/

Rule 10b-5 under the Securities Exchange Act of 1934 makes it unlawful, in connection with the purchase or sale of any security, for any person by the use of jurisdictional means to, among other things, make any untrue statement of a material fact or omit to state a material fact necessary in order to make statements made, in the light of the circumstances under which they were made, not misleading. 19/

18/ There has been some disagreement among the courts as to whether there is any right of private action under Section 17. 6 Loss, "Securities Regulation" 3912-3915 (2d ed. Supp. 1969).

19/ With respect to private actions under Rule 10b-5 for damages, a plaintiff must prove scienter, i.e., an intent to deceive, manipulate, or defraud on the defendant's part. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

VI. Problems that may be anticipated as arising under a rule pursuant to Section 10(b).

(A) Problems concerning whether an advertisement is limited to information the substance of which is included in the Section 10(a) prospectus.

It can be anticipated that questions will arise as to whether the substance of information included in an advertisement is included in the Section 10(a) prospectus. While this standard has the advantage of not requiring that an idea always be communicated in the same words, it may result in a question arising as to whether different words express the same idea. Situations may arise in which there is no obvious answer or with respect to which reasonable men might differ. Even if all determinations were perfectly coordinated, this might still lead, given the role advertising may be credited with in an investment company's success or lack of success in competing with other investment companies for investor interest, to charges of arbitrariness and unfairness on the part of the Commission in its review of investment company advertising.

(B) Problems as to whether an advertisement is misleading.

As has been stated, if a Section 10(a) prospectus contained, for example, performance figures, a rule under Section 10(b) permitting any advertisement to include any information the substance of which is included in the Section 10(a) prospectus would permit performance figures to be included in an advertisement. This may create problems since performance figures in and of themselves may be misleading. For example, a fund may have increased 25% while the S & P 500 increased 50%. The prospectus, let us assume, includes both facts because a statement of just the fund's increase may be misleading in the absence of an indication of what an unmanaged fund experienced during the same period. Alone, information about the fund's increase may, in the context of an offer of sale, contain an implication or give rise to an inference of advisory competence which would not exist if the information concerning the experience of an unmanaged account during the same period was also given. There may be other factors that should be stated to prevent statements being made about performance from being misleading. In the extreme, one might say that the whole statutory prospectus is required. The promulgation of the rule would, of course, implicitly reject this view. Nevertheless, there may be serious questions, and reasonable disagreement, in any particular case, as to whether certain information contained in a prospectus is also necessary in an advertisement to prevent information that it contained in the advertisement, which is also contained in the prospectus, from being misleading.

(C) Effective administration of a rule under Section 10(b) would probably require an increase in the staff since it would add responsibilities to staff and make significant demands on staff time.

Even if a rule under Section 10(b) does not require pre-clearance of an advertisement, it can be expected that, given the expense of the creation of television advertising, the opinion of the staff would be requested on a television layout before a commercial is produced.

In any event, the staff would be required to monitor advertisements shortly after their use. While this review might be carried out on a random basis and, therefore, not require the amount of staff time that would have to be expended if advertisements were required to be filed as parts of registration statements, even a random review would require that significant staff attention be devoted to advertising. Furthermore, if any determination by the Commission that an advertisement is impermissible is contested, the staff would be required to engage in a proceeding.

While at the present time an advertisement for an investment company; i.e., a Rule 134 communication or a piece of sales literature that is preceded or accompanied by a Section 10(a) prospectus, is required to be filed with the Commission pursuant to Section 24(b) of the 1940 Act, in the usual case, prior to its being filed with the Commission, it is carefully reviewed by the National Association of Securities Dealers for compliance with Rule 134 and the Statement of Policy 20/ on permissible and impermissible sales literature.

The review by the staff of advertisements made pursuant to the proposed rule might have to be more extensive and intensive than staff review of the materials filed under Section 24(b) of the 1940 Act because such latter materials are either the limited Rule 134 advertisement or sales literature that is preceded or accompanied by a Section 10(a) prospectus.

It seems probable, therefore, that a new rule under Section 10(b) would add to staff responsibilities and make significant demands on staff time. Hence, effective administration of the rule would probably require additional staff to do the job.

20/ Investment Company Act Release Nos. 3856, 2621 (October 31, 1975).

VI. Interplay of a rule under Section 10(b) and Rule 134.

Although the existence of Rule 134 in its expanded form together with a new rule under Section 10(b) may be confusing, we do not recommend that the Commission consider revoking Rule 134, in its expanded form as it applies to investment companies, if it decides to promulgate a new rule under Section 10(b). Rule 134 would not be rendered superfluous by a new rule under Section 10(b) for the following reasons: (1) the information contained in an advertisement permitted by the new rule would be limited to information included in a Section 10(a) prospectus, (2) an advertisement under the new rule would be a prospectus subject to the provisions of Section 12(2) of the 1933 Act, and (3) the Commission could by its own order halt the use of an advertisement made under the new rule if it found it to be misleading. None of these factors would apply to an advertisement made pursuant to Rule 134.

It is possible that certain advertisements may comply with the provisions of Rule 134 and not with the provisions of the new rule, other advertisements may comply with the provisions of the new rule and not with Rule 134, and some advertisements may comply with both.

When compliance of an advertisement with the provisions of Rule 134 is in doubt, we would expect that the advertisement would be filed pursuant to the new rule so long as it complied with the provisions of that rule. Filing under the new rule should not, however, be deemed a waiver of any claim that the advertisement also satisfies the provisions of Rule 134.

If an advertisement is permitted by a rule under Section 10(b) or by Rule 134 there does not seem to be much point in determining whether it is also permitted under the other rule. Therefore, it would, ordinarily, not be necessary to determine whether an advertisement complied with the new rule and with Rule 134. Compliance with one or the other would be sufficient to permit the advertisement.

VII. Possible amendments to Rule 134.

We have already stated why we believe that Section 2(10)(b) and Rule 134 thereunder do not present a proper basis for permitting advertisements to contain information about performance. However, a previously mentioned problem under present Rule 134 can be solved by amendment to that rule. This is the restriction limiting the use of the expanded tombstone to investment companies which have effective registration statements.

We believe that existing Rule 134 should be amended so as to permit the use of the expanded tombstone advertisement during the so-called waiting period, i.e., the time between the filing of a registration statement and the time the statement becomes effective, as well as after the registration statement has become effective. If, in response to an advertisement made prior to effectiveness, an investor requests that a statutory prospectus be sent to him, he can be sent a prospectus which meets the requirements of Rule 433.

VIII. Recommendation.

The Commission should publish the attached release which give notice of its consideration of (1) a new rule under Section 10(b) to be designated Rule 434d, and (2) an amendment to Rule 134 to remove the present restriction limiting expanded tombstone advertisements to investment companies whose registration statements under the Securities Act of 1933 have become effective.

Prepared by: Judd 50213

SECURITIES AND EXCHANGE COMMISSION

[17 CFR Part 230]

[Release No. ; File No. S7-]

ADVERTISING BY INVESTMENT COMPANIES

AGENCY: Securities and Exchange Commission

ACTION: Proposed Rule 434d and amendment to existing Rule 134 relating to Investment Company Advertising.

SUMMARY: A rule is being proposed for public comment under which any investment company registered under the Investment Company Act of 1940 ("1940 Act") which has filed a registration statement under the Securities Act of 1933 ("1933 Act") would be permitted to advertise with respect to the securities referred to in such registration statement 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 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, excepting 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). It is also proposed that Rule 134 be amended to remove the restriction limiting the use of expanded tombstone advertisements to investment companies whose registration statements under the 1933 Act have become effective.

DATES: Comments must be received on or before _____, 1977.

ADDRESS: Comments should be sent in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Washington, D. C. 20549 and should refer to File No. S7-____.

FOR FURTHER INFORMATION CONTACT: Stanley B. Judd, Division of Investment Management, Securities and Exchange Commission, Washington, D.C. 20549 (202) 755-0213.

SUPPLEMENTARY INFORMATION

Notice is hereby given that the Securities and Exchange Commission has under consideration the adoption of a rule under the Securities Act of 1933 (the "1933 Act") [15 U.S.C. 77a et seq.] which would permit any investment company registered under the Investment Company Act of 1940 (the "1940 Act") [15 U.S.C. 80a et seq.] which has filed a registration statement under the 1933 Act to advertise with respect to the securities referred to in such registration statement 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) [17 CFR 230.433(b)].

The Commission also has under consideration the adoption of an amendment to rule 134 [17 CFR 230.134] under 1933 Act that would remove the prohibition presently contained in the

rule with respect to the use by investment companies, during the time between the filing of a registration statement and the time the statement becomes effective, of an advertisement which contains information that the rule presently permits only after effectiveness.

The new rule would be adopted pursuant to the authority granted the Commission in sections 10(b), 10(c), 10(d), 10(f) [15 U.S.C. 77j(b),(c),(d), and (f)] and 19(a) [15 U.S.C. 77s(a)] of the 1933 Act. The amendment to rule 134 would be adopted pursuant to sections 2(10) [15 U.S.C. 77b(10)] and 19(a) of the 1933 Act.

I. BACKGROUND

Investment companies, like other issuers, are restricted in their opportunities to advertise sales of their securities by the following: (1) section 2(3) [15 U.S.C. 77b(3)] of the 1933 Act which defines an "offer to sell" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or an interest in a security, for value; (2) subsection (c) of section 5 [15 U.S.C. 77e(c)] of the 1933 Act which makes it unlawful for any person to make use of any means or instruments of transportation or communication in interstate

commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise, any security unless a registration statement has been filed as to such security; (3) section 2(10) of the 1933 Act which includes an advertisement in the definition of a prospectus; and (4) section 5(b)(1) [15 U.S.C. 77e(b)(1)] of the 1933 Act which prohibits the use of jurisdictional means to carry or transmit any prospectus relating to any security with respect to which a registration statement under the 1933 Act has been filed unless such prospectus meets the requirements of section 10 [15 U.S.C. 77j] of the 1933 Act. Under section 10(a) [15 U.S.C. 77j(a)] of the 1933 Act, prospectuses are required to contain, with certain exceptions, information which section 7 [15 U.S.C. 77g] of the 1933 Act, and Schedules A and B thereunder, require to be included in a registration statement.

There are three exceptions to the general requirement that public communications offering securities for sale be in the form of section 10(a) prospectuses.

(1) Section 2(10)(a) [15 U.S.C. 77b(10)(a)] excepts from the definition of a prospectus, a communication preceded or accompanied by a written prospectus meeting the requirements of section 10(a). It is under this exemption that investors have been sent sales literature preceded by or together with a section 10(a) prospectus.

(2) Section 2(10)(b) [15 U.S.C. 77b(10)(b)] excepts from the definition of a prospectus,

> "a notice, circular, advertisement, letter or communication in respect of a security . . . [which] states from whom a written prospectus meeting the requirements of section 10 may be obtained and, in addition, 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 or 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."

This second exception, and rule 134 thereunder, permit the so-called "tombstone" advertisement.

(3) The third exception from the general scheme of regulation is provided by section 10(b) which authorizes the Commission by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors to permit the use of a prospectus, for the purposes of subsection (b)(1) of section 5, which omits in part or summarizes information in the prospectus specified in sub-

section 10(a). It is under this provision that the Commission has authorized the "summary prospectus".

Because the only "product" of the typical investment company is its shares and because it is in continuous registration, any advertisement for such a company is a prospectus that is illegal unless it complies with statutory requirements. As a result, investors cannot learn about an investment company, as they can learn about other companies, from advertisements of its products or policies or from widely disseminated annual reports to shareholders or similar publications. Moreover, since 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, these limitations may be preventing investors from getting information about all relevant investment possibilities. To the extent that more information is available to investors, they are likely to be better informed and able to make better investment decisions. Since the allocation of capital is, in large measure, made through numerous private economic decisions, it is a matter of public interest that those decisions, in the aggregate, be intelligent and well informed.

It, therefore, appears to be appropriate in the public interest that as much freedom in investment company advertising be permitted as is possible consistent with the protection of investors and the purpose of the securities acts.

II. PROPOSED NEW RULE.

It does not appear that the summary prospectus, as permitted by rule 434a [17 CFR 230.434a], is used to any extent as an investment company advertisement in public media such as newspapers and magazines of general circulation and on radio and television.

While the requirements of rule 434a may be appropriate with respect to a document, such as a summary prospectus as now permitted, which an investor might reasonably confuse with a statutory prospectus, they may be neither necessary nor appropriate with respect to a brief advertisement in a newspaper or

magazine of general circulation or on radio or television.

Pursuant to section 10(d) of the 1933 Act, the Commission is authorized, in the exercise of its powers under subsections (a), (b), and (c) of section 10, to classify prospectuses according to the nature and circumstances of their use or the nature of the security, issue, issuer, or otherwise, and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and contents which it may find appropriate and consistent with the public interest and the protection of investors.

Section 19 [15 U.S.C. 77s] of the 1933 Act also gives the Commission general authority to make such rules and regulations as may be necessary to carry out the provisions of that Act, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers.

In view of the special problems of investment companies under the general pattern of regulation under the 1933 Act, the fact that advertisements in newspapers and magazines of general circulation and on radio and television are open to public scrutiny, and the impracticality of advertising in

these public media by means of the summary prospectus permitted by rule 434a, the Commission is considering adopting a rule under sections 10(b), 10(c), 10(d), 10(f). and 19(a) of the 1933 Act that would deal only with brief advertisements on behalf of investment companies in newspapers and magazines of general circulation and on radio or television. The proposed rule would not permit investment companies to use a new form of written communication in direct mailings that would supplant the summary prospectus as presently permitted. Furthermore, the proposed rule, like the present newspaper prospectus rule, rule 494, would not apply to reprints reproductions or detached copies of a permitted advertisement.

(A) The information that may be contained in an advertisement under the proposed rule.

Advertisements made pursuant to the proposed rule would be limited to information the substance of which is contained in a section 10(a) prospectus. This is because section 10(b) permits the Commission only to authorize the use of a prospectus for the purpose of subsection (b)(1) of section 5 which omits in part or summarizes information in the prospectus

specified in section 10(a). Therefore, any information in an advertisement permitted under section 10(b) must be limited to information which is in the prospectus specified in section 10(a). This includes information that is voluntarily put into the section 10(a) prospectus as well as information required to be there. Thus, if a prospectus contains information on performance, the rule would permit the information to be included in an advertisement. However, the words used in an advertisement to convey an idea would not have to be the exact words that were used in the prospectus or registration statement to convey the same idea, and visual or audio advertising techniques could be used to convey information contained in the statutory prospectus even though such techniques are not themselves part of the section 10(a) prospectus.

(3.) Any advertisement made pursuant to the proposed rule under section 10(b) would be subject to those provisions in the securities laws and the rules thereunder which deal with false or misleading statements.

Any advertisement made pursuant to the proposed rule under section 10(b) would not be excepted from the definition of a prospectus. It could, therefore, serve as a basis for rescission or damages under section 12(2) [15 U.S.C. 771(2)] of the 1933 Act if it contained a materially untrue statement or omitted to state a material fact necessary to make the statements made, in the light of the circumstances in which they were made, not misleading. It might also serve as a basis for action under section 17(a) [15 U.S.C. 77q(a)] of the 1933 Act or section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] and rule 10b-5 [17 CFR 240.10b-5] thereunder.

Section 17(a) of the 1933 Act makes it unlawful, in the offer or sale of a security by jurisdictional means, among other things, to obtain money or property by means of any untrue statement of a material fact or any omission to state a

material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

Rule 10b-5 under the Securities Exchange Act of 1934 makes it unlawful, in connection with the purchase or sale of any security, for any person by the use of jurisdictional means, among other things, to make any untrue statement of a material fact or omit to state a material fact necessary in order to make statements made, in the light of the circumstances under which they were made, not misleading.

Any advertisement would also be "sales literature" as that term is used in the "Statement Of Policy" (as Amended November 5, 1957) Investment Company Act Release No. 2621 and, thus, subject to the policy stated therein as to what constitutes materially misleading information.

(C.) Advertisements under the proposed rule are limited to 600 words, excluding required legends, and charts and graphs.

To preserve the section 10(a) prospectus as the primary selling document, it is desirable that the length of advertisements be limited since they might otherwise tend to cause investors to regard the section 10(a) prospectus as superfluous. While advertisements should not be so long as to cause this to happen, they should be long enough to provide whatever information is necessary to prevent the information that is contained from being misleading.

Consideration was given to the idea that it would be sufficient to require that an advertisement under any new rule, like an advertisement under rule 134, merely be "brief." While there is merit in this approach, in that it permits flexibility, there are serious objections to it. First, even though rule 134 permits advertisements which contain only particular classes of information, questions have frequently arisen as to whether advertisements purportedly under rule 134 satisfy the requirement of the rule that they be brief. Questions concerning the meaning of the word "brief" would be even more likely under a rule which would permit any information in the registration statement to be included in an advertisement. Second, many questions of interpretation

under a new rule are likely to arise and it would appear desirable to use objective, definite criteria, if feasible. Third, a rule should be precise enough to provide guidance and, thus, justify enforcement. For these reasons, the proposed rule contains precise limits on length.

The proposed limit is on the number of words that may be contained in an advertisement under the rule. Other limits may be as efficient as a word limit and, perhaps, more practical. The Commission invites suggestions in this regard.

In fixing the word limitation, a limit was sought that would not be so long as to cause investors to regard a statutory prospectus as superfluous and yet be long enough to permit any information to be presented that would be necessary to prevent other information stated from being misleading. The length of randomly selected advertisements on the financial pages of newspapers and magazines was also considered. These considerations have led to the proposal of a word limit of 600 words, excluding required legends, and charts and graphs.

The question of whether it would be sufficient to limit a permitted advertisement to "about" 600 words was also examined. Although such a requirement would provide a degree of flexibility, it would lead to interpretative questions and probably result in some other absolute figure such as 650 or 699 becoming the limit. Thus, the proposal contains an absolute limit.

To deal with questions that may arise as to what constitutes a "word" or "one advertisement" for purposes of the 600 word limitation, the proposed rule provides (1) that a word shall include any abbreviation, contraction, or other shortened representation of a word, or a number consisting of one or more digits (2) words joined by a hyphen shall be counted as separate words, and (3) advertisements presented in a manner likely to cause their contents to be integrated cumulatively shall be considered as one advertisement, but television or radio commercials spaced more than one-half hour apart, or on different stations or channels, or advertisements in separate publications shall not be considered as one

advertisement. To illustrate this latter point, if two different advertisements for the same investment company appeared on the same page or successive pages of a newspaper, this would be a factor that would probably cause them to be regarded as one advertisement for purposes of the rules. However, if they were identical advertisements, they would be regarded as separate advertisements for purposes of the rule.

(D.) The proposed rule requires any advertisement under the rule to state from whom a section 10(a) prospectus containing more complete information may be obtained and that an investor should read that prospectus carefully before investing.

The 1933 Act intended the statutory prospectus to be the primary selling document. Nevertheless, an investor can purchase a security which he learns about from an advertisement or a salesman before receiving a statutory prospectus. Therefore, to preserve the statutory prospectus as the primary selling document while liberalizing what may be included in advertising, it is necessary that the advertisement itself state from whom a section 10(a) prospectus may be obtained, that such prospectus contains more complete information than is contained in the advertisement, and that an investor should read the statutory prospectus carefully before investing.

The proposed rule requires that this statement be "conspicuous". It does not specify the size, or type face to be used.

(E.) The proposed rule requires any advertisement under the rule used prior to the effectiveness of a registration statement to carry the legend required by rule 433(b) [17 CFR 230.433(b)], but does not require advertisements under the rule to carry the legend required in all prospectuses by rule 425 [17 CFR 230.425].

If an advertisement is used prior to effectiveness of a registration statement (but after the registration statement has been filed), the advertisement must contain the statement required by rule 433(b) under the 1933 Act. __/

__/ Rule 433(b) requires the outside front cover page of a prospectus used prior to the effective date of a registration statement to contain the following statement. "A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. Information contained herein is subject to completion or amendment. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This prospectus shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sales of these securities in any State in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state."

However, it does not seem necessary that advertisements under the rule also carry the legend required in all prospectuses by rule 425. _/

(F.) An advertisement made pursuant to the proposed rule is not required to be filed as part of a registration statement, but is required to be filed with the Commission shortly after use.

Section 10(b) provides that a prospectus permitted thereunder shall, except to the extent the Commission by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors otherwise provides, be filed as part of the registration statement but shall not be deemed a part of such registration statement for the purposes of section 11 [15 U.S.C. 77k]. _/

_/ Rule 425 requires that the following legend be set forth on the front page of any prospectus:

"These securities have not been approved or disapproved by the Securities and Exchange Commission nor has the Commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense."

_/ Section 11(a), generally, makes directors, professionals, underwriters, etc. liable to purchasers of securities in case a part of a registration statement for which they are responsible, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements made therein not misleading.

If an advertisement under the proposed rule was required to be filed as part of a registration statement, the effect would be to require pre-clearance by the staff of any advertisement made pursuant to the rule. This would impede the advertising process and, for the following reasons, it is not considered necessary.

(1) The proposed rule would require that any advertisement made pursuant to the proposed rule be filed with the Commission not later than the first day the Commission is open for business following the day such advertisement is first used, so that the staff can monitor such use at least on a random basis.__/ This would enable the Commission to exercise the power given to it by section 10(b) to prevent or suspend the use of an advertisement pursuant to a rule under the section if it has reason to believe that the advertisement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the

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__/ Radio broadcasts are permitted to be filed in the form of scripts and television broadcasts are permitted to be filed in the form of scripts and story boards.

statements therein, in the light of the circumstances under which such advertisement is, or is to be, used, not misleading.

(2) Advertisements under the rule would be limited to information the substance of which must be included in a registration statement. Thus, while an advertisement itself would not be a basis for liability under section 11 of the 1933 Act, the substance of any information in the advertisement would have had to have been in the registration statement, which is subject to section 11 when it becomes effective. The substance of any information included in an investment company advertisement would, therefore, be information with respect to which directors, accountants, underwriters, or others might be liable to purchasers of the company's securities if it was false or misleading and if it was included in the registration statement when it becomes effective.

(3) Because the investment company concerned is in the best position to know whether an advertisement about the company is misleading and because the company may be liable if it is, the proposed rule requires the investment company to file an advertisement made pursuant to the rule with the Commission.

The company could, of course, delegate the task of filing the advertisement to another person such as its underwriter. Under the proposed rule, therefore, an investment company or its designated agent would have to approve advertisements for the company which are made pursuant to the rule.

Therefore, the Commission proposes to except advertisements made pursuant to rule 434d from the requirement that they be filed as part of a registration statement.

Filings under the rule would be accepted as satisfying the requirement of section 24(b) [15 U.S.C. 80a-24(b)] of the 1940 Act which makes it unlawful for certain investment companies, i.e., open-end companies, unit investment trusts, and face amount certificate companies, or their underwriters, in connection with a public offering of any security of which such a company is the issuer, to make use of the mails or other instrumentalities of interstate commerce to transmit advertisements and other sales literature addressed to or intended for distribution to prospective investors unless three copies have been filed with the Commission or are filed with the Commission within ten days thereafter. In other words, duplicate filings would not be required.

III. Interplay of the proposed rule and rule 134.

Although the simultaneous existence of rule 134 in its expanded form and a new rule under section 10(b) would introduce an additional complexity, the Commission does not propose to revoke rule 134 in its expanded form as it applies to investment companies. Some persons might choose to rely on rule 134 for the following reasons: (1) the information contained in an advertisement permitted by the new rule would be limited to information included in a section 10(a) prospectus, while an advertisement under rule 134 is not so limited, (2) an advertisement under the new rule, unlike an advertisement pursuant to rule 134, would be a prospectus subject to the provisions of section 12(2) of the 1933 Act, and (3) the Commission could by its own order halt the use of an advertisement made under the proposed rule if the rule was not complied with or if it believed that the advertisement was misleading.

It is possible that certain advertisements may comply with the provisions of rule 134 and not with the provisions of the new rule. other advertisements may comply with the provisions of the new rule and not with rule 134. and some advertisements may comply with both.

When compliance of an advertisement with the provisions of rule 134 is in doubt, it is expected that the advertisement would be filed pursuant to the new rule so long as it complied with the provisions of that rule. Filing under the new rule would not, however, be deemed a waiver of any claim that the advertisement also satisfies the provisions of rule 134. It would, ordinarily, not be necessary to determine whether any advertisement complied with both the new rule and rule 134. Compliance with one or the other would be sufficient to permit the advertisement.

IV. Proposed Amendment to Rule 134.

Prior to 1972, rule 134, the "tombstone rule", 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 certain specified information.

After liberalizing amendments in 1972, the rule was further amended in 1974 to permit additional information with respect to an open-end investment company whose registration statement under the 1933 Act is effective and whose securities are the subject of a continuous offering pursuant to such registration statement.

In 1975, the rule was amended again to make use of the expanded investment company advertisement permissible for any investment company issuing redeemable securities whose registration statement under the 1933 Act is effective.

Prior to the 1974 amendment some advertisements of investment companies, with and without effective registration statement, described the company's objectives and policies in the course of indicating whether in the selection of investments emphasis was placed upon income or growth characteristics.

Under the present rule, such a description can be used only in an advertisement of an investment company issuing redeemable securities which has an effective registration statement. The amendments, therefore, may be deemed to prohibit pre-effective advertising that was permissible prior to the amendments. This, however, was not the intent of these amendments.

The Commission, has, therefore, reconsidered the question of whether the expanded tombstone should be restricted to investment companies issuing redeemable securities which have effective 1933 Act registration statements and proposes to amend rule 134 so as to permit the use of the expanded tombstone advertisement during the so-called waiting period: i.e., the time between the filing of a registration statement and the time the statement becomes effective, as

well as after the registration statement becomes effective. If, in response to an advertisement made prior to effectivness, an investor requests that a statutory prospectus be sent to him, he can be sent a prospectus which meets the requirements of Rule 433.

TEXT OF PROPOSED RULE 434d AND AMENDED RULE 134.

Rule 434d as proposed would read as follows:

§230.434d Advertisement by an investment company as satisfying requirements of section 10.

(a) An advertisement shall be deemed to be a prospectus under section 10(b) of the Act for the purpose of section 5(b)(1) of the Act if

(1) it is with respect to an investment company registered under the Investment Company Act of 1940 which has filed a registration statement for its securities under the Act,

(2) it appears in a newspaper or magazine of general circulation or on radio or television,

(3) it contains only information the substance of which is included in the section 10(a) prospectus,

(4) it states, conspicuously, from whom a prospectus containing more complete information may be obtained and that an investor should read that prospectus carefully before investing.

(5) it is limited to not more than 500 words, excluding required legends, and charts and [illegible]

(6) it contains the statement required by section 230.433(b) when used prior to effectiveness of the registration statement.

(b) An advertisement made pursuant to subparagraph (a) of this section need not contain the statement required by section 230.425.

(c) An advertisement made pursuant to subparagraph (a) of this section need not be filed as part of the registration statement filed under the Act, but three copies of any such advertisement, including a recording or transcript of any radio broadcast and recording or transcript and story board of any television broadcast shall be filed with the Commission under this section by the investment company concerned not later than the end of the first business day the Commission is open following the day the advertisement first appears, and any such advertisements shall be subject to the suspension powers of the Commission under section 10(b) of the Act.

(d) For purposes of this section a word shall include any abbreviation, contraction, or other shortened representation of a word, a number consisting of one or more digits shall be counted as one word, and words joined by a hyphen shall be counted as separate words. Further, for purposes of this section, advertisements presented in a manner likely to cause their contents to be integrated cumulatively shall be considered as one advertisement, but television or radio commercials spaced more than one-half hour apart or on different stations or channels or advertisements in separate publications shall not be considered as one advertisement.

In so far as is relevant here, rule 134, as amended, would read as follows with the material to be deleted in brackets.

§230.134 Communications not deemed a prospectus.

The term "prospectus" as defined in section 2(10) of the act shall not include a notice, circular, advertisement, letter, or other communication published or transmitted to any person after a registration statement has been filed if it contains only the statements required or permitted to be included therein by the following provisions of this section:

(a) Such communications may include any one or more of the following items of information, which need not follow the numerical sequence of this paragraph.

* * *

(3) A brief indication of the general type of business of the issuer, limited to the following:

* * *

(iii) In the case of an investment company registered under the Investment Company Act of 1940, the company's classification and subclassification under the Act . . . any graphic design or device or an attention-getting headline, not involving performance figures, designed to direct the reader's attention to textual material included in the communication pursuant to other provisions of this rule, and with respect to an investment company issuing redeemable securities [whose registration statement under the Act is effective] (A) a description of such company's investment objectives and policies, services, and method of operation . . ."

All interested persons are invited to submit their views and comments on the proposed rule and the proposed amendment in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Washington, D.C. 20549 on or before . All such communications should refer to File No. S7- and will be available for public inspection.

By the Commission

George A. Fitzsimmons
Secretary