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OFFICE OF THE COMMISSIONER

MEMORANDUM OF CONVERSATION

Inw Co Advertising

May 10, 1978

TO: Files

FROM: W. Randolph Thompson
Attorney, Division of Investment Management

SUBJECT: Conversation between Commissioner Roberta S. Karmel,
Lee B. Spencer, Associate Director, Division of
Investment Management, Stanley B. Judd, Assistant
Chief Counsel, Division of Investment Management,
W. Randolph Thompson, Attorney, Division of Investment
Management, David Silver, President, Investment Company
Institute, and Matthew Fink, General Counsel, Investment
Company Institute.

On April 11, 1978, David Silver and Matt Fink, of the Investment Company Institute ("ICI") met with Commissioner Roberta Karmel, Lee Spencer, Stanley Judd, and W. Randolph Thompson in the office of Commissioner Karmel. Mr. Silver stated that his purpose in requesting a meeting with Commissioner Karmel had been to respond to questions raised by Commissioner Karmel in her speech on mutual fund advertising to mutual fund industry representatives at the March, 1978 Mutual Fund Conference.

Mr. Silver and Mr. Fink praised Commissioner Karmel's speech, saying that it had "thrown the ball back to their court." Mr. Silver then stated that the advertising code envisioned by the ICI's February 9, 1978, presentation to the Commission was not intended to be one that would be drafted by the mutual fund industry, but rather by either the Commission or the NASD. Mr. Silver then stated that, in response to a question on page 13 of Commissioner Karmel's speech, the use of Rule 434a summary prospectuses envisioned by the ICI was strictly as an accompaniment to sales literature in direct mailings, and not as a part of the ICI's proposed modification of Rule 134.

Mr. Silver then expressed his opinion that current mutual fund prospectuses under Section 10(a) of the Securities Act of 1933 ("1933 Act") are unusable for any purpose other than reading material for attorneys-- that they are terrible documents in general. Mr. Silver stated that Rule 434a summary prospectuses are the type of document upon which the "average investor" should be able to rely in making investment decisions, since they contain all the information an investor would need and would be written in more comprehensible language.

Mr. Judd then pointed out that performance figures are not used in Rule 434a summary prospectuses, and that an investor would not necessarily be able to obtain all the information which he would need to make an investment decision from that type of document. Mr. Silver agreed with this statement, but added that he had meant that the summary prospectus, in conjunction with the sales literature with which he had suggested such prospectuses be allowed to be used, would provide a sufficient basis for investment decisions.

Mr. Judd stated that sales literature could never be used with a Rule 434a prospectus without legislative change, since such sales literature would itself be a prospectus, in the absence of the accompaniment of a full Section 10(a) prospectus. Mr. Judd further stated that, in his opinion, Mr. Silver was suggesting that Section 10(a) prospectuses should be revised and shortened, since if it is possible to draft a shorter form of prospectus sufficient to provide adequate disclosure to investors, it should be done in all cases, not just for mutual fund direct mailings. Mr. Silver agreed that Section 10(a) prospectuses should be shortened and simplified in all cases.

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Mr. Silver then said (in response to Commissioner Karmel's March, 1978, statement that Rule 434d advertising should not be allowed to be used in direct mailings since sales literature is already permitted when accompanied by a full prospectus) that the statutory prospectus is such a foreboding document that an investor receiving one probably thinks he is being sued.

Mr. Spencer then stated that, to the extent that Mr. Silver's criticisms involve the statutory prospectus, he should remember that the Commission staff is currently working on revising that document's requirements.

Commissioner Karmel then suggested to Mr. Silver that advertising and sales literature are two distinct areas. Mr. Silver agreed, but stated that there are areas where the two overlap and those areas are troublesome.

Mr. Judd then asked what role would remain for the Section 10(a) prospectus under the ICI's proposal. Mr. Silver responded that it would be a "rescission document." Until after receipt of the full prospectus and time to evaluate it, an investor could rescind his purchase of mutual fund securities. In other words, no sale would be final until after receipt of the full prospectus and time to read it.

Mr. Silver then pointed out that money market funds and municipal bond funds now receive many telephone inquiries regarding their shares and have no time to deliver a full prospectus before an investment decision is made. Big customers now want their money invested in such funds within the hour. Commissioner Karmel asked whether this meant same-day settlement on such purchases. Mr. Silver replied that same-day settlement was, in fact, what he had meant. Money is made available to the funds and is invested that same day.

Commissioner Karmel then asked Mr. Silver whether that would mean a completed sale could precede the receipt of a prospectus and Mr. Silver responded that it would. Commissioner Karmel then pointed out that, in that case, there could be no rescission rights after receipt of a full prospectus (under the Uniform Commercial Code) without legislative change.

Mr. Spencer and Mr. Judd then pointed out that Congress had been aware of such possible completed sales prior to receipt of prospectuses when it had amended the Securities Act of 1933 to say that delivery of the full prospectus is required only at delivery of the security (interpreted to mean "with the confirmation of sale").

Mr. Silver then stated that what should be considered is what makes sense assuming a clean slate. Whether legislative change would be required to implement any changes found to be needed should be considered only after the policy issues are resolved.

Mr. Judd then said that, according to his understanding, there are two basic policies underlying the 1933 Act. The first policy is that there should be liability for those who sell securities as a result of having misled investors. The second policy is that when securities are offered to the public by an issuer, certain material information specified by Congress must be presented in the issuer's prospectus.

Mr. Fink answered Mr. Judd by saying that no one had any problems with the validity of the first policy and that the second policy could be answered by legislative change to provide for a ten-day rescission right to substitute for the requirement of the presentation of the material information specified by Congress in the 1933 Act.

Mr. Silver then stated that, in his opinion, the ICI proposal and proposed Rule 434d constitute "moderate" reform, while legislative change or total expansion of Rule 134, as suggested by Commissioner Karmel's list of possible options in her speech, constituted more radical reform.

Mr. Fink then said that the ICI proposal would make Rule 134 a "fraud rule" with a "master Statement of Policy" in the form of an advertising code.

Commissioner Karmel then asked what role the NASD would play in the ICI proposal. Mr. Silver pointed out that there would be a jurisdictional problem involved in any NASD role since many funds selling at no-load are not subject to the NASD's jurisdiction. Mr. Silver then stated that there has been a difference between what has been allowed by the Commission staff in mutual fund advertising under existing regulation and what has been allowed by the NASD, with the NASD having been more stringent than the staff.

Mr. Judd then asked whether the use of sales literature under Section 2(10)(a) of the 1933 Act would be "dead" if Rule 434d advertisements were to be permitted in direct mailings without a full prospectus. Mr. Silver agreed that use of Section 2(10)(a) mailings would be eliminated. He added that perhaps in such mailings performance data could be "reserved out."

Mr. Fink then pointed out that careful study of the 1933 Act's various requirements "makes your mind go fuzzy," and stated that what is needed is for everyone to step back and take a fresh look at the whole problem without feeling tied to the existing requirements of the 1933 Act. Commissioner Karmel agreed that the 1933 Act's regulatory scheme is a "morass," and that a step back to view the issues from a policy standpoint is needed.

Mr. Silver stated that the mutual industry, which forms the ICI's "constituency", is divided into two camps. He said that the group of funds which favor only moderate reform is made up of funds which do not have money to use for advertising, those which are dealer-distributed, those which don't believe in the efficacy of advertising, and those which fear a "Gresham's Law" effect of bad conduct by certain advertisers driving down the ethical conduct of others in the competition for sales. Those funds which make up the group favoring more radical reform include the no-load funds, those which think they have something to advertise (such as performance or a full line of investment vehicles), those which believe that more freedom in advertising is needed to enable funds to compete with other financial institutions, and those which feel strongly about the First Amendment.

Mr. Silver next stated that he felt that the approach of the reform outlined in proposed Rule 434d was ingenious within the present statutory framework, but that he had several problems with that rule. One problem which he cited was that the rule does not answer certain questions such as whether advertisements under the rule must include the information or the wording of the full prospectus. In that regard, he questioned whether attention-getting headlines would be permitted, since such headlines would not be included in the prospectus. He pointed out that there could be questions typified by the question of whether Fidelity would be able to use its "frog advertisements" without eliminating the frog, since it was not in its prospectus. Mr. Judd responded that Rule 434d was aimed at information, not wording and both Mr. Judd and Mr. Spencer assured Mr. Silver that the Fidelity frog could be used without putting it into Fidelity's prospectus.

Commissioner Karmel pointed out that she felt there is a general liberalizing trend in government's approach to regulating private industry.

Mr. Spencer stated that the Commission could deal with most of Mr. Silver's objections to Rule 434d by comments, Mr. Spencer further stated that the staff's primary problems with liberalizing mutual fund advertising are "lawyerly" problems involving consistency with the 1933 Act.

Commissioner Karmel said that it appeared that the mutual fund industry wants both comfort and freedom and that for the industry to expect more freedom, it should be prepared to accept more responsibility. Mr. Silver answered that any regulated industry looks for safe harbors.

Mr. Fink asked what the informal reaction would be to a proposal containing ten-day rescission rights, liability of the type found in Section 12(2) of the 1933 Act and legislative change to accomplish these goals. Mr. Spencer stated that he, personally, would be responsive to such a proposal. Commissioner Karmel said that the Commission would be willing to consider such a proposal, but that the industry might not get what it wants from such a proposal. Mr. Judd stated that he could not see the difference between mutual funds and industrial companies with regard to the applicability of such a proposal.

Mr. Silver then expressed the opinion that there should be different disclosure requirements for mutual funds than for industrial companies.

Mr. Silver then stated that the ICI was to have a series of meetings in the near future. There will be an executive committee meeting on April 28, 1978, and a full board meeting on May 15, 1978. He hoped that those meetings would resolve whether the ICI would press for moderate or radical advertising reforms.

WRT/mlm