Judd

MEMORANDUM

DATE: January 30, 1978

TO: Robert Pozen, Assistant General Counsel

FROM: Stan Judd, Assistant Chief Counsel
Division of Investment Management

RE: Memorandum of Professor David Ratner ("Ratner") to David Silver, President of the ICI, re the implications of recent Supreme Court decisions, which indicate that commercial speech is protected under the first amendment to the constitution, for the Commission's regulation of mutual fund advertising.

Ratner's memorandum has two thrusts. The first is his argument that section 5 of the '33 Act, as applied to mutual funds, is in violation of the first amendment to the constitution. The implications of this argument are that enforcement of section 5 with respect to mutual funds is unconsititutional and that, therefore, the Commission cannot, and should not seek to, enforce section 5 with respect to mutual funds.

The distinction between mutual funds and other companies is not persuasive. Therefore, Ratner's argument is, essentially, an attack on section 5 and, therefore, the whole scheme of regulation under the '33 Act. We do not believe that the Supreme Court intended to invalidate this pattern of regulation.

The second is his criticism (pages 25-28) of the limitations contained in proposed rule 424(d). This rule, which was intended to permit greater freedom in investment company advertising, was based, in part, on the rationale contained in the Virginia State Board of Pharmacy decision. See the annexed excerpt from the release giving notice of the proposed rule. Also see Memorandum to the Commission from the Division of Investment Management re Advertising by Investment Companied dated April 29, 1977, page 7 footnote 1.

Most of the limitations contained in the proposed rule, such as those restricting advertisements made pursuant to the rule to asvertisements of not more than 600 words in newspapers or

magazines of general circulation, could be deleted without destroying the statutory basis for the rule. But the removal of the condition in the proposed rule restricting such advertisements to information contained in a filed registration statement, which Ratner has critized (see item "2" page 26), would destroy the basis for Commission action pursuant to section 10(b) of the Act which provides that the Commission may permit a prospectus to be used that omits in part or summarizes information contained in the full prospectus.

Ratner specifies no other statutory basis under which the Commission would have the power to exempt general mutual fund advertisements from the provisions of section 5 or declare that such advertisements would satisfy the requirements of that section. We do not believe that section 2(10)(b) provides such authority, and Ratner seems to agree since he says (page 20, 21) that it only permits " a notice which states from whom a statutory prospectus can be obtained, and contains such other limited information as may be specified by the SEC" (emphasis added).

An inference that might be drawn from Ratner's criticism of the proposed rule, is that the Commission should adopt a similar rule but with the criticized limitations deleted. Such an inference, however, would be invalid since the Commission is without statutory power to adopt such a rule.

It should also be noticed that the inference which might be drawn from Ratner's criticism of the proposed rule, i.e., that the rule should be passed without the criticized limitations, is not the same as the implication contained in his argument that section 5 is unconstitutional as applied to mutual funds, which is that the Commission should not enforce section 5 as to mutual funds.

Ratner goes on to state explicitly what the Commission can do (pages 28, 29). He says that the Commission can adopt rules prohibiting false or misleading statements in mutual fund advertising

and can impose sanctions for violations of such rules, without regard to whether the false or misleading statements were made willfully or negligently. In this connection, we would only point out that the necessity for such rules is questionable since section 17(a) of the '33 Act, among other prohibitions, already prohibits, in the offer or sale of any securities by use of the means of transportation or communication in interstate commerce or by use of the mails, the obtaining of money or property by means of a false or misleading statement, and that section 12(2) of the '33 Act already contains a very strong sanction for sales of securities by means of false or misleading statements, whether made willingly or negligently, which is the right of a purchaser to rescind the transaction.

In summary, Ratner's argument is that the Commission should take action under the '33 Act only against misleading mutual fund advertisements. The ICI however, as we understand it, is requesting, in effect, that (1) the Commission, exempt mutual fund advertisements from the requirements of section 5 of the '33 Act by exempting such advertisements from the definition of a prospectus and (2) that the Commission with the help of the industry should define which advertisements containing selling information, such as past performance data, are not misleading. This would give the users of such advertisements immunity from suit under the '33 Act and the '34 Act. Ratner's memorandum does not address the following issues that would be posed by such a request:

(1) the authority of the Commission to exempt such advertisements from the requirements of section 5 of the '33 Act and

(2) the possibility of the Commission being able to determine the kinds of advertisements containing selling information, including information about past performance, which are not misleading.