

MEMO# 14737

May 21, 2002

SEC PROPOSES AMENDMENTS TO INVESTMENT COMPANY ADVERTISING RULES; CONFERENCE CALL SCHEDULED FOR JUNE 11TH

[14737] May 21, 2002 TO: ADVERTISING COMPLIANCE ADVISORY COMMITTEE No. 11-02 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 22-02 SEC RULES COMMITTEE No. 42-02 SMALL FUNDS COMMITTEE No. 7-02 UNIT INVESTMENT TRUST COMMITTEE No. 12-02 RE: SEC PROPOSES AMENDMENTS TO INVESTMENT COMPANY ADVERTISING RULES; CONFERENCE CALL SCHEDULED FOR JUNE 11TH The Securities and Exchange Commission has proposed for comment amendments to rules under the Securities Act of 1933 and the Investment Company Act of 1940 relating to investment company advertising.¹ In particular, the Commission has proposed to amend Rule 482 to: (1) eliminate the “substance of which” requirement, thereby permitting mutual funds to include in an advertisement information that is not included in the statutory prospectus;² (2) enhance the disclosure in fund performance advertisements by imposing additional specific disclosure requirements; and (3) require that an advertisement that includes performance information include a toll-free phone number where investors can obtain total return quotations current to the most recent month-end.³ The Commission has also proposed to revise the “tombstone ad” rule (Rule 134) to exclude registered investment companies from relying on it; and to revise Rule 156 to provide further guidance regarding the factors to be weighed in considering whether a statement involving a material fact in investment company sales literature is or might be misleading. To accommodate the revisions proposed to Rules 482 and 134, the Commission has proposed amendments to various forms used by investment companies, including Form N-1A.⁴ The Commission’s proposal is briefly summarized below. 1 SEC Release No. 33-8101 (May 17, 2002) (the “Release”). The cites to pages of the Release in this memorandum are to the version of the Release available through the SEC’s website, www.sec.gov. 2 The National Securities Market Improvement Act of 1996 (NSMIA) amended the Investment Company Act to permit, subject to rules adopted by the Commission, the use of prospectuses under Section 10(b) of the Securities Act that include information the substance of which is not included in the Section 10(a) prospectus. 3 In addition to the substantive revisions proposed to Rule 482, the Commission has proposed to reorganize the rule to make it easier to use. These revisions include adding headings to the rule, simplifying certain provisions without changing their content, reordering provisions in the rule, and grouping provisions by topic. 4 The other forms the Commission has proposed to revise are Forms N-3, N-4, and N-6. 2 Comments on the proposed amendments must be filed with the SEC by Wednesday, July 31, 2002. The Institute will hold a conference call on Tuesday, June 11th at 2:00 to discuss the proposed

amendments. If you are interested in participating in the call, please e-mail your contact information to Deborah Washington (deborah@ici.org) by Friday, June 7th. If you are unable to participate in the call, please provide your comments on the proposed amendments to Tami Reed by Monday, June 10th by phone (202-326-5825), fax (202-326-5839) or e-mail (tamara@ici.org).

I. PROPOSED REVISIONS TO RULE 482

A. Eliminating the "Substance of Which" Requirement As mentioned above, the Commission has proposed to eliminate the "substance of which" requirement from Rule 482. This change is intended to permit investment companies to include more information in Rule 482 advertisements on a real-time basis. It would also permit funds to eliminate from their statutory prospectuses information that clutters the prospectus and obscures more important information. All Rule 482 ads would, however, remain subject to liability under Section 12(a)(2) under the Securities Act and the antifraud provisions of the federal securities laws, as well as to any applicable advertising rules of NASD Regulation, Inc. The Commission's Release emphasizes in several places that mere compliance with the terms of Rule 482 is not a safe harbor against antifraud liability. To further emphasize this point, however, the Commission has proposed to add a note to proposed paragraph (a) of Rule 482 stating that an advertisement that complies with the rule does not relieve the fund, underwriter, or dealer of the obligation to ensure that the advertisement is not false or misleading.⁵

B. Enhancing Fund Advertising Disclosure under Rule 482 In order to encourage advertisements to convey balanced information to prospective investors, the Commission has proposed enhancing the disclosure required by Rule 482 to 5 This note would also cross reference Rule 156 under the Securities Act, which provides guidance about the factors to be weighed in determining whether statements, representations, illustrations, and descriptions contained in fund advertisements and sales literature are misleading. The SEC has also proposed to add a similar note to the introductory paragraph of Rule 34b-1 under the Investment Company Act with respect to supplemental sales literature.⁶ This part of the Commission's proposal is substantially similar to recommendations the Institute made to the Commission in July 2001. In particular, the Institute recommended that the Commission revise Rule 482 to require: (1) narrative disclosure alerting investors to potential changes in advertised returns and directing them to a source for more current performance data, such as a website or toll-free telephone number; (2) funds to provide average annual total return information for one, five, and ten year periods, current to at least the most recent month end via telephone, website, or both, at the fund's direction; and (3) the recommended disclosure be included in the body of an advertisement, and not in a footnote, and that it appear in close proximity to the presentation of the performance numbers. See Letter from Craig S. Tyle, General Counsel, ICI, to Mr. Paul F. Roye, Director, SEC Division of Investment Management, dated July 18, 2001.

3 include the following narrative information in any advertisement that contains performance figures:

- A statement that past performance does not guarantee future results;
- A statement that current performance may be lower or higher than the performance data quoted; and
- A toll-free (or collect) telephone number where an investor may obtain performance data current to the most recent month-end.

(See discussion under C, below.) All Rule 482 ads would also be required to note that information about charges and expenses is contained in the statutory prospectus. The narrative disclosure required by the rule would be required to be presented 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 ad. In addition, the statements required in connection with advertising performance would be required to be presented in close proximity to the performance data and, in a print advertisement, would be required to be presented in the body of the advertisement and not in a footnote. In connection with these proposed requirements, the Commission seeks comment on the following:

- Are there alternative methods for encouraging important explanatory information to be given sufficient prominence in a Rule

482 ad? • Should the Commission require a font size larger than the 8-point type required under Rule 420 for the required disclosures? • Are the proposed presentation requirements feasible for radio and television advertisements? • Are there specific presentation requirements that should apply to the use of electronic media? • Are there other requirements that should apply to fund performance ads in order to help ensure that performance is presented in a manner that is accurate, balanced, and not misleading? C. Performance Information: Required Availability of Monthly Performance As mentioned above, as proposed to be revised, Rule 482 would require advertisements to include a toll-free number⁷ where investors could obtain total return quotations current to the most recent month-end, available within three calendar days of such month-end.⁸ The Release⁷ The Release notes that the Commission considered whether to provide funds greater flexibility in determining the medium through which to make month-end numbers available so that a fund could, for example, meet its obligation through website access. The Commission concluded however, that at this time requiring telephone access would ensure the most widespread access. Nevertheless, the Commission encourages each fund to make its month-end performance information available to its investors on its website, if it has one, or by any means available to the fund. ⁸ According to the Release, the month-end information obtained through the telephone call would not be considered part of the advertisement. ⁴ notes that the Commission had considered amending Rule 482 to require ads to include total return calculations current to the most recent calendar month ended prior to submission of the advertisement for publication. While the Commission was not persuaded that the benefits to investors from this approach would outweigh the costs it would impose,⁹ it has sought comment on whether fund should be required to provide more current performance information in all advertisements and, if so, how current such information should be (e.g., month-end, week-end, or some other period). In addition to seeking comment on whether the Commission should require disclosure of performance more current than month-end, the Commission seeks comment on various issues related to this requirement, including the following: • Should the information provided by phone be updated more frequently than monthly (e.g., weekly or daily)? • Should the toll-free number be required if the ad itself includes performance data current to the most recent month-end? • Is three calendar days an appropriate period of time after each month-end in which to require funds to make available month-end information by phone? (If not, what would be an appropriate period – e.g., 1 day, 5 days?) • Is telephone access the best alternative or is another (e.g., website access) better? • Should funds have the flexibility to determine which medium to use to provide the more current information? • What would be the cost of requiring access to month-end data by phone for those funds that do not currently provide this access? • Should funds whose daily performance information is available in the press be required to refer to the availability of the daily information in their performance advertisements? II. PROPOSED REVISIONS TO RULE 134 The Commission has proposed to amend Rule 134 to exclude registered investment companies from being able to utilize tombstone ads. Instead, all fund advertisements would be subject to Rule 482. According to the Release, the Commission believes that elimination of the “substance of which” requirement from Rule 482, which will enable funds to increase the amount of information they include in a Rule 482 advertisement, will obviate the need for funds to rely on Rule 134. Moreover, because, unlike Rule 482 ads, tombstone ads are not subject to liability under Section 12(a)(2) (because they are not considered advertisements or prospectuses for purposes of Section 12(a)(2)), the Commission believes that excluding fund ads from reliance on Rule 134 will increase investor protection by subjecting all information in fund ads to liability under Section 12(a)(2). ⁹ The Release notes that, while this approach would have the advantage of providing the more current information in the ad rather than requiring the investor to seek it out through a phone call, such a requirement may: increase

the number of instances in which performance information for different periods appeared concurrently as a result of different lead times for different publication; result in according very recent performance greater status than it deserves, thereby contributing to investors' tendency to focus excessively on short-term performance; and, increase fund costs by, for example, shortening the "shelf life" of sales material provided in bulk to third-party intermediaries such as broker-dealers and retirement plan sponsors. 5 In connection with the proposed revisions to Rule 134, the Commission seeks comment on the following: • Should funds be excluded from relying on Rule 134? • If funds should continue to be permitted to rely on Rule 134, how, if at all, should Rule 134 be amended? • In the alternative, should only certain types of funds (e.g., closed-end funds or business development companies) be able to use Rule 134 advertisements? III. PROPOSED REVISIONS TO RULE 156 The Commission has proposed to amend Rule 156, relating to investment company sales literature, to provide further guidance regarding the factors to be weighed in considering whether a statement involving a material fact in investment company sales literature is or might be misleading. In particular, Rule 156 would be revised to state more explicitly that portrayals of past income, gain, or growth of assets may be misleading where the portrayals omit explanations, qualifications, limitations, or other statements necessary or appropriate to make these portrayals of past performance not misleading. These revisions are intended to address the Commission's concerns with fund performance advertisements that do not provide adequate disclosure (i) of unusual circumstances that have contributed to fund performance; (ii) that more current performance may be lower than advertised performance; and (iii) that would permit an investor to evaluate the significance of performance that is based on selective dates. IV. PROPOSED FORM AMENDMENTS The Commission has proposed amendments to various registration forms, including Form N-1A, to accommodate the proposed revisions to the advertising rules. These revisions would, in part, prescribe the methods of calculation to be used if performance data is included in the prospectus and eliminate the requirements for information intended to satisfy the "substance of which" requirements. These amendments are intended to eliminate from the statutory prospectus boilerplate disclosure that clutters the statutory prospectus and obscures other important information. The Release emphasizes that if a fund chooses to include any performance information in its prospectus or statement of additional information (SAI) that is not required to be included by the applicable registration form, the fund is responsible for ensuring that the information is not incomplete, inaccurate, or misleading. Thus a fund should include any disclosure that is required to meet this responsibility (e.g., the method of calculating performance, the dates of performance, and the tax rates used). In addition to seeking comment on the proposed revisions to the forms, the Commission seeks comment on whether, if the Commission eliminates the "substance of which" requirement from Rule 482, there are other reasons why a fund should continue to be required to include information about its methods of calculating performance in its prospectus or SAI. For example, comment is sought on whether a fund should be required to include in the SAI a description of the methods by which any non-standardized performance is calculated. 6 V. REQUEST FOR COMMENT ON THE FRAMEWORK FOR REGULATING MUTUAL FUND ADS In addition to seeking comment on the specific rule and form amendments discussed above, the Commission seeks comment generally on whether the framework for regulating investment company ads should be modified and whether it would be better to require ads to adhere to general standards rather than the Commission prescribing any regulation of the content of ads, including standards for performance advertising. The Release invites comments on this and other numerous specific issues related to the regulation of investment company advertising including, for example, the appropriate role of NASDR in establishing advertising standards, whether fund ads should be required to include information about a variety of factors that

are important in making an investment decision, and what liability should apply to fund ads. VI. COMPLIANCE DATE The Commission intends that the amendment eliminating the “substance of which” requirement from Rule 482 would take effect immediately upon the effective date of the amendments. The Commission would also expect to require fund advertisements used 90 days or more after the effective date of the amendments to comply with the amendments. The Commission has requested comment on whether the 90-day period would be an appropriate transition period and whether compliance should be based on the date an advertisement is used, submitted for publication, or on another date.

***** Tamara K. Reed Associate Counsel

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.