INVESTMENT COMPANY ADVERTISING

SEC Regulation Has Changed from Specific Guidelines for Advertisers to a General Antifraud Provision. Despite Greater Latitude, Conflicts May Arise Between the Commission’s Regulation and First Amendment Protection of Commercial Speech.

By Tamar Frankel* 

The Supreme Court’s recent extension of First Amendment protection to commercial speech covers investment company advertising and puts the SEC’s regulation of this advertising to a test. Since 1974, the SEC has embarked on a program to relax its advertising rules. Nonetheless, it has been suggested that in light of the Court’s decision, the SEC may be compelled constitutionally to expand its deregulatory program. The resolution of this issue must await further decisions. Judicial doctrine on the constitutional protection of commercial speech is still developing and so case involving a challenge to the SEC’s authority to regulate investment company advertising has yet been reported.

In 1979, however, the SEC changed the 40-year-old basic pattern of its regulatory scheme with respect to investment company advertising. It withdrew its statement of policy, which provided advertisers with a safe harbor by setting forth acceptable formats of advertising on various subjects, and adopted instead an antifraud provision by interpretative rule 196 under the Securities Act. The shift from SEC prescription of advertising formats to a general antifraud provision gave advertisers freedom to design their materials but at the same time exposed them to the inevitable uncertainty that accompanies freedom. The SEC announced—as part of its new scheme—that the staff will rarely pass on advertising prior to its use. In addition to rule 196, section 24(b) of the Investment Company Act requires mutual funds (open-end investment companies) to file their advertising with the SEC and consequently makes them subject to the general antifraud provision with respect to materials filed with the SEC.

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with the SEC. The new scheme not only eliminates prior restraint on speech but also seems to be within an exception mentioned by the Supreme Court to the First Amendment protection of commercial speech for proprietary materials. It is, therefore, doubtful whether it will be affected by future Court decisions. However, as wide as the SEC’s regulatory horizons may be, they are not without limit.

Until 1970, the Supreme Court had held that commercial speech was wholly unprotected by the First Amendment. In Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc., 381 U.S. 709, 86 S. Ct. 1693, 16 L.Ed.2d 738 (1966), the Court held that a ban on prescription-drug price advertising violated the First Amendment since "commercial speech, like other varieties, is protected." The distinction of First Amendment protection in Virginia was justified on the following grounds. First, the advertiser has an economic interest in disseminating his message; second, the consumer has an interest in knowing where his dollars will be spent most effectively; and third, society has an interest in "intelligent and well-informed" decision making by consumers regarding commercial transactions. The presence of these interests, however, resulted in only limited First Amendment protection. The Court made it clear that because commercial speech is generally more objective and harder than political speech, it requires a different degree of protection.

Moreover, since commercial speech is motivated by financial self-interest, it is less likely to be subjected to any measurable degree of regulation. Thus the scope of First Amendment protection afforded to investment company advertising should be determined by balancing the First Amendment value of advertising against the legitimate federal interest in regulating this advertising.

One of the principal grounds for protecting commercial speech is that its dissemination will inform the public of the availability, nature, and prices of products and services; this information will in turn assure "intelligent and well-informed" decision making by consumers. State First Amendment barriers attach only to truthful advertising; the government should remain free to prohibit false and misleading advertising. Moreover, in Ohrabik v. Ohio State Bar Association the Court observed that when individual and social goals underlying advertising are not likely to be served, as in situations inherently conducive to overreach- ing and deception, or when permitting advertising may inhibit consumers from making informed decisions about goods and services, prophylactic measures may be appro-

Numerous examples could be cited of communications that are regulating without offending the First Amendment, such as the exchange of information about securities, [and] . . . matters of corporate policy. . . . Each of these examples illustrates that the state does not lose its power to regulate commercial activity deemed harmful to the public whenever speech is in a form of that activity. Neither Vigeur v. Church of Scientology of Cal. nor American Telephone & Telegraph Co. v. United States is contrary to this proposition. No other First Amendment cases involving regulation of commercial speech establish the same general rule with respect to the Regulation of Business Interests by Government. . . .

Although this passage is dictum, it indicates that the Court recognized the need for antitrust regulation in the securities area. The Oliner statement also indicates that the Court deemed proxy materials to be commercial speech even though the materials may affect the shareholder's financial interest only indirectly through a vote on corporate matters, and that it considered the interest of proxy solicitors of the kind unlikely to be blunted by governmental regulation.

When circumstances weaken these assumptions the need for First Amendment protection will be stronger. Thus as the subject matter of commercial speech moves from financial information regarding the issuer to general information regarding public affairs and from misleading to controversial information, the federal interest in regulating the truthfulness of the statement may at some point give way in favor of the free flow of ideas. . . . Congress determined over 40 years ago that the nation had an interest in protecting investors and maintaining the integrity of the securities market. . . . Because securities cannot be evaluated or understood and because pertinent information is not always publicly available, Congress chose to protect potential investors by allowing the SEC to regulate the information disseminated to them. The purpose of these securities statutes, like the goal underlying protection of commercial speech, is the furtherance of "important and valuable decision-making" by investors. To the extent that SEC regulation of investment company advertising promotes similar goals, it will probably be deemed not to offend the First Amendment. . . .

The current state of the law leaves advertisers with great uncertainty. There is little sophistication in this area, and cases on rule 10b-5 under the Exchange Act may not be helpful in resolving specific advertising problems. The SEC's position, however, is fairly clear and consistent. In withdrawing its statement of policy the SEC announced that its views, as expressed in that statement, remained unchanged. In addition, rule 156 demonstrates the SEC's opinion that a combination of false statements may nonetheless be misleading either because, by qualifying words and the like, the SEC is including a statement that is misleading in such a manner which would imply that gains or income realized in the past would be repeated in the future, and this implication had no basis in fact. . . .

Rule 156 is open-ended and ambiguous. There are great complexities in determining what constitutes statements that are misleading, especially when their impact results from a combination of statements that, when separate, are accurate. The law of mutual fund advertising has little judicial exposition, very little by the Supreme Court, kept largely within decades within the straightjacket of SEC directives. The new rule 156 and other antifraud provisions necessitate judicial construction and development of federal common law. The requirement of misrepresentation has been histori-
cally within judicial expertise. However, the "constitutionalization" of the law regulating securities advertising would not necessarily follow as a matter of course. While the First Amendment plays a role, the courts need not engage in determining the balance of competing First Amendment and governmental interest cases by case. Rather the courts should adhere to the established First Amendment approach. When the advertising concerns particular investments of the advertiser or its investment adviser, and the public cannot independently evaluate the material, the government's interest in regulation is strong, and the balance should be struck in favor of regulation. When the advertising concerns general public matters, however, different considerations are at stake. This subject matter may be closest to ideological and political speech and may therefore be entitled to the most stringent protection generally available to that category of speech.

29. This latter should be read at a different level. See generally Nimmer, The Right to Speak From Above: A First Amendment Theory Applied to Libel and Misrepresentation in Privacy, 56 Cal. L. Rev. 935, 955-960 (1968).

ACCOUNTING DEVELOPMENTS

By Dennis S. Neiser and Charles Haaslom

SEC ACCOUNTING BULLETINS

With the recent issuance of Staff Accounting Bulletin No. 45, the SEC deleted the first 38 SABs (Staff Accounting Bulletins) and replaced them with an integrated package that has been updated, arranged by topic, and indexed. The new codified version deletes material no longer necessary because of new developments in generally accepted accounting principles. It also acknowledges the recent revision of the SEC's disclosure rules under the various securities acts—for example, it updates references to regulation B-2A, whose structure and content have changed substantially.

The codification does not include the material in SAB No. 39, issued in October 1980, which interprets certain accounting rules relevant dealing with the independence of accountants. Neither does it refer to SAB 41 (released last month), which says that publicly held oil companies should not consider President Reagan's decision to accelerate oil decarburization in their calculations of future net revenues, but should use the oil prices in effect at December 31, 1980 for 1980 calendar year reporting. (A schedule of future net revenues is one of the annual SEC reporting requirements for oil and gas producers.) In SAB 41 the SEC's staff also responded to questions on the effect of the windfall profits tax on the computation of future net revenues, suggesting that companies should assume the termination of the tax in 1993.

OIL AND GAS PRODUCERS

After a three-year study of the feasibility of reserve recognition accounting ("RRA") for oil and gas producers, the SEC has decided not to require the use of RRA, (an accounting method based on value and not cost) as the standard for preparing basic financial statements. Indeed, the Commission announced that it would support the FASB in developing a comprehensive package of supplemental disclosure requirements for oil and gas producers. Although the SEC feels that both the "full cost" and the "successful-efforts" methods now used in the industry have serious shortcomings, FASB Chairman Donald J. Kirk announced recently that the Board will not reexamine the permissibility of either method.