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SPECIAL SECTION: JAPAN TRADE

BUREAUCRATIC PRACTICES IN JAPAN AND THE UNITED STATES AND THE REGULATION OF ADVERTISEMENTS BY INVESTMENT ADVISORS

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INTRODUCTION

Much has been written about the "unique" character of the administrative system in Japan.[1] For economic matters, in particular, commentators have stressed the powerful and intrusive role played by the Japanese bureaucracy.[2] Yet, the bureaucracy often

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1. The best recent contribution in this area is KAREL VAN WOLFEREN, THE ENIGMA OF JAPANESE POWER: PEOPLE AND POLITICS IN A STATELESS NATION (1990).

2. *See* CHALMERS JOHNSON, MITI AND THE JAPANESE MIRACLE: THE GROWTH OF INDUSTRIAL POLICY, 1925-1975 (1982). For a more detailed examination of the regulation of the Japanese financial markets, particularly by the Ministry of Finance, see J. ROBERT BROWN, JR., OPENING JAPAN'S FINANCIAL MARKETS (1994).

relies on a more personal form of regulation, emphasizing oral, informal advice, and eschewing written regulation.[3]

Differences between these two approaches become particularly clear when comparing the administrative states in Japan with the United States. Where the Japanese system is opaque and stresses informal advice and unwritten positions, the U.S. system is transparent and emphasizes procedures and legal norms. While Japanese agencies often disregard the strictures of the relevant statutory framework, U.S. agencies remain tethered to the language of the enabling act and the intent of Congress.

Recognizing the differences does not, however, explain why they emerged. The tendency is to treat the Japanese system as arising from unique cultural and historical factors. This suggests that the administrative states in Japan and the United States are unlikely to converge, a conclusion of considerable consequence.[4] Alternatively, the differences may also have a less complex, less immutable explanation. They may result from relatively conventional modes of bureaucratic behavior.

When comparable conditions exist in the U.S., including vaguely worded statutes and an absence of effective judicial or political review, the regulatory approach takes on the attributes of the Japanese bureaucracy. This can be illustrated by comparing the regulation of advertisements by investment advisors in the United States and in Japan. Subject to almost no judicial review, this area of regulation in the United States can be characterized by personal decision making, micro-management, informal interpretations, and positions that exceed the statutory mandate. In short, the area has the characteristics commonly attributed to the Japanese system.

This article will first provide an overview of the administrative states in the United States and Japan, highlighting the apparent differences. Sections II and III examine the regulatory approach in the two countries and the specific context of advertising by investment advisors. Sections IV and V again compare the two states, showing that, at least in the area of advisor adver-

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3. The Japanese themselves characterize this approach as "unique." *See* Michael K. Young, *Judicial Review of Administrative Guidance: Governmentally Encouraged Consensual Dispute Resolution in Japan*, 84 COLUM. L. REV. 923, 925 n.6 (1984).

4. The issue of convergence is more than academic. In the area of foreign access, Japan has largely removed flagrant barriers to entry. One of the most significant and most subtle impediments, however, concerns a stifling degree of micromanagement by the Japanese bureaucracy. *See* text accompanying notes 121-25 *infra*. Foreign financial entities have difficulty achieving the economies of scale and freedom of operations necessary to be profitable. To the extent bureaucratic practices in the two countries converge, foreign firms would obtain greater operating latitude in Japan.

tisements, the differences recede and the similarities predominate. The analysis suggests that the differences in the behavior of the two administrative states can be better explained through conventional bureaucratic behavior and not through cultural and historical factors.

I. THE ADMINISTRATIVE STATES IN JAPAN AND THE UNITED STATES

A. THE UNITED STATES

By all appearances, the United States and Japan have very different administrative states. The United States might fairly be described as highly legalistic, with considerable emphasis on procedure. In particular, the Administrative Procedure Act ("APA") has taken on immense, almost talismanic, importance in the regulatory process.[5] The APA contains procedural requirements defining the relationship between regulated and regulator, including mandatory publication and comment procedures for agency rules[6] and restrictions on *ex parte* contacts.[7]

The process contemplates broad participation. Proposed rules must be published in the Federal Register, a periodical that places the public on notice of an impending change in policy.[8] The agency must provide a reasonable time for comment and must disclose the administrative thought process involved in reaching the final result.[9]

5. 5 U.S.C. §§ 551-59 (1988).

6. 5 U.S.C. § 553(a-b) (1988). One commentator has described the key elements of the rule of law in the administrative context as neutrality, adherence to existing rules or precedent, reasoned elaboration, and dignitary rights of participation and confrontation. CHRISTOPHER F. EDLEY, JR., ADMINISTRATIVE LAW: RETHINKING JUDICIAL CONTROL OF BUREAUCRACY 23 (1990).

7. In the context of rule making, the APA does not expressly prohibit *ex parte* contacts. *See* 5 U.S.C. § 553 (1988). Some cases, however, have done so as a matter of interpretation. They have found that *ex parte* contacts not otherwise disclosed render the record on appeal incomplete. *See* Home Box Office Inc. v. FCC, 567 F.2d 9 (D.C. Cir.), *cert. denied*, 434 U.S. 829, *reh'g denied*, 434 U.S. 988 (1977). *But see* Action for Children's Television v. FCC, 564 F.2d 458 (D.C. Cir. 1977). Putting *ex parte* contacts aside, the courts are generally united in holding that the use of facts not disclosed in the record as a basis for decision making prevents effective judicial review. *See, e.g.*, Air Products & Chemicals, Inc. v. FERC, 650 F.2d 687 (5th Cir. 1981).

8. 5 U.S.C. § 553(b) (1988). Notice must include the time, place, and nature of any public rule making proceedings, the relevant statutory authority, and either the terms or substance of the rule or a description of the subject issues involved. *Id.*

9. The APA does not specify a time period for the comment process but only that interested persons be given "an opportunity to participate . . . ." 5 U.S.C. § 553(c) (1988). The comment period may be avoided by a showing of good cause. 5 U.S.C. § 553(b). *See also* Riverbend Farms, Inc. v. Madigan, 958 F.2d 1479 (9th Cir.), *cert. denied*, 113 S. Ct. 598 (1992).

To be sure, participation cannot always be equated with influence. Agencies may receive comments but decline to incorporate them into the final rule. Nevertheless, the process at least requires agencies to address significant comments.[10] Cavalier disregard or inadequate explanations can be a basis for challenging the rule.[11]

Not all agency positions arise out of the APA rule making process. "Informal" positions abound. All regulatory schemes have unspoken norms and unwritten policies.[12] These can take the form of understandings, oral advice, or informal written pronouncements such as no-action letters and revenue rulings.[13] Those subject to regulation, however, often exploit gaps in the system. As a result, agencies frequently find themselves dealing with matters on a post-hoc basis.[14]

Administrative agencies assigned the task of developing the necessary regulations often receive only marginal deference from those subject to oversight.[15] A handful of exceptions aside, the bureaucracy has typically been treated as inflexible, uninformed,

10. A promulgated rule must be accompanied by an explanation of the significant comments received during the process. 5 U.S.C. § 553(c) (1988).

11. In the administrative context, rules must be supported by an adequate record. *See* Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402 (1971). To the extent the record contains significant, but explained, comments, the court may view the record as inadequate and the rule as arbitrary. *See* Motor Vehicle Mfr. Assoc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983).

12. Unwritten rules have a way of disappearing once challenged. Until 1985, the Securities and Exchange Commission had not expressly prohibited discriminatory tender offers. This occurred in large part from the belief that they were invalid, either under state or federal law. A desperate company in 1985 refused to stand on convention and made a discriminatory tender offer. When the practice was challenged, the courts found no infirmity. *See* Unocal Corp. v. Pickens, 608 F. Supp. 1081 (C.D. Cal. 1985). Only then did the Commission act and adopt an express prohibition. *See* Rule 14d-10, 17 C.F.R. § 240.14d-10 (1992).

13. The prevalence of oral advice in the United States government has rarely been examined in a detailed, comprehensive fashion. Yet most agencies have an institutionalized process for dispensing oral advice—whether the IRS Tax Information Service or the Chief Counsel's Office within the Division of Corporation Finance at the SEC. Moreover, these offices typically have an internal manual for use by officials dispensing the advice; manuals sometimes obtainable under the Freedom of Information Act, 5 U.S.C. § 552 (1988). *See, e.g.*, Linoz v. Heckler, 800 F.2d 871, 878 n.11 (9th Cir. 1986). The persistence of oral interpretations can be seen from the existence of an entire body of law that has arisen over the right to rely on oral advice from an administrative agency. *See, e.g.*, Schweiker v. Hansen, 450 U.S. 785 (1981).

14. For a discussion of this action-reaction process in an administrative context, see J. Robert Brown, Jr., *Regulatory Intervention in the Market for Corporate Control*, 23 U.C. DAVIS L. REV. 1 (1989).

15. The parties affected by a regulatory approach may not act in a particularly deferential manner toward the policy. Legal challenges to agency action are common. The courts, in contrast, have propounded a rule of law that defers to agencies when interpreting ambiguous language. *See* Chevron v. Natural Resources Defense Council, 467 U.S. 837 (1984).

and out of touch with actual practices.[16] The regulated community constantly tests the boundaries of agency authority, with litigation an accepted part of the administrative process.[17]

Often given broad statutory mandates, agencies have considerable regulatory discretion. Laws commonly contain a catch-all provision that permits the relevant agency to adopt rules necessary to implement the law.[18] The broad discretion has caused concern over accountability, with limitations on administrative authority a much-debated topic.[19] In general, the court system has been viewed as the most significant mechanism for constraining agency discretion.[20]

B. JAPAN

The Japanese system seemingly operates in a much different fashion. In fleshing out legislative schemes, the Japanese bureaucracy has generally eschewed formalistic approaches.[21] The

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16. *See, e.g.*, JAMES M. LANDIS, REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT 1-18 (1960).

17. Cases of administrative interpretation have become so prevalent that they now account for a substantial portion of the Supreme Court's docket. For an excellent empirical study of judicial review of administrative proceedings, see Peter H. Schuck & E. Donald Elliott, *To the Chevron Station: An Empirical Study of Federal Administrative Law*, 1990 DUKE L.J. 984.

18. The Securities and Exchange Commission, for example, has the authority to adopt rules "to carry out the purposes" of the Securities Act of 1933. *See* 15 U.S.C. § 77s. To some extent, the broad grant of authority ought to raise Constitutional concerns over delegation of powers. *See, e.g.*, A.L.A. Schechter Poultry Corp. v. U.S., 295 U.S. 495 (1935). Despite occasional misgivings, however, the Supreme Court has not invalidated a delegation of rule making authority since the Depression. *See* Indus. Dept. v. American Petroleum Inst., 448 U.S. 607 (1980).

19. Particularly noticeable have been efforts by the executive branch to achieve greater accountability over the administrative process. The Office of Information and Regulatory Affairs within the Office of Management and Budget has become a centralized repository for review of regulatory initiatives by executive branch agencies. *See* Exec. Order No. 12,498, 50 Fed. Reg. 1036 (1985). For a discussion of this review process, see Thomas O. McGarity, *Regulatory Reform and the Positive State: An Historical Overview*, 38 ADMIN. L. REV. 399 (1986). The review process does not, however, encompass independent agencies. Their relative independence has sometimes caused them to be characterized as a headless fourth branch of the government. *See* THE PRESIDENT'S COMM. ON ADMINISTRATIVE MANAGEMENT, REPORT OF THE COMM. WITH STUDIES OF ADMINISTRATIVE MANAGEMENT IN THE FEDERAL GOVERNMENT 39-40 (1937).

20. The APA has institutionalized the process of judicial review of agency decisions. *See* 5 U.S.C. § 706 (1988). The existence of judicial review, however, begs the question of how far the courts can and should go in overseeing administrative decision making. The Supreme Court would seem to want more judicial restraint, *see* Chevron v. Natural Resources Defense Council, 467 U.S. 837 (1984), Rust v. Sullivan, 497 U.S. 1002 (1991), although the decisions have not been consistent, *see, e.g.*, Good Samaritan Hospital v. Shalala, 113 S. Ct. 2151 (1993). Whatever the precise standard, however, courts seem very involved in the administrative process.

21. Given the vagueness of the laws, the bureaucracy in Japan has extraordinary discretion, at least by U.S. standards. This enables the bureaucracy to react with

country has no APA or comparable provisions.[22] Nor have written rules become the preferred mechanism for articulating policies.[23] Instead, policies are most commonly transmitted informally through "administrative guidance."[24]

The informality of the process has necessitated close relationships and constant contact between regulators and regulated and has resulted in a fundamentally different regulatory premise. Particularly in the financial sector, banks, securities firms, and investment advisors tolerate significant limits on their operations and accept a high degree of industry uniformity. They typically do not act unless authorized. Any deviation from the usual patterns within the relevant industry requires bureaucratic acquiescence, something sought sparingly. Moreover, with few avenues of appeal, bureaucratic pronouncements ordinarily represented the final word on an issue.[25]

The bureaucracy, therefore, has greater authority than in the United States.[26] It is more intimately involved in industry affairs and is subject to less oversight. Decisions have a less legalistic, highly personal tone. The bureaucracy also seems better able to ensure uniformity and compel greater adherence to the relevant regulatory scheme.

considerable flexibility to changed circumstances. *See* Yoshiharu Matsuura, *Law and Bureaucracy in Modern Japan*, 41 STAN. L. REV. 1627, 1634 (1989) ("The Japanese bureaucracy retains considerable flexibility. Laws regulating industrial activities frequently delegate broad discretion to national ministries and local bureaucracies, without specific guidelines.").

22. Calls have arisen in Japan for an administrative procedure act, with the matter under study. *See, e.g.*, CORP. EXEC'S URGE NEW ADMIN. PROCEDURES LAW, Japan Economic Newswire, Apr. 2, 1990, *available in* LEXIS, World Library, JEN File.

23. This should not suggest that written policies are completely absent. Circulars and ordinances are relatively common. *See infra* notes 127 and 128. They do not, however, result from a system of notice and comment, and they can be altered without procedural safeguards.

24. *See* discussion *infra* part I.B.1.

25. *See infra* text accompanying notes 49-53.

26. A growing body of literature suggests that in Japan, the bureaucracy, rather than the courts, represents the principal vehicle for social change. *See* FRANK K. UPHAM, LAW AND SOCIAL CHANGE IN POSTWAR JAPAN (1987). Stated another way, the legislature in Japan, as with Congress in the United States, often seeks to avoid politically difficult and sensitive issues. In the United States, Congress leaves matters for judicial determination. In Japan, matters are instead left to the bureaucracy. The two systems differ, however, in that Congress overturns court decisions with some frequency, albeit in a small percentage of cases. *See* Susan S. Grover, *The Silent Majority: Martin v. Wilks and the Legislative Response*, 1992 U. ILL. L. REV. 43 (discussing congressional reversal of a Supreme Court decision interpreting the Civil Rights Act). In Japan, the Diet rarely intervenes to reverse administrative policies.

1. *Source of Control*

Unlike the more formalistic U.S. system, Japanese bureaucrats rely less on written regulations and pronouncements in favor of "administrative guidance."[27] "[I]nformal and generally oral"[28] administrative guidance involves "advice" on the proper approach or policy to be taken by the relevant business. Sometimes distributed in face-to-face meetings at the ministry, guidance is also dispensed on the phone, at social occasions, and at other informal convocations. By eschewing written edicts, government officials can disavow responsibility when things go wrong, avoiding blame.[29]

Guidance extends to ambiguous provisions in the statutory framework and other areas of regulatory uncertainty. The concept, however, is much broader. Bureaucracies such as the Ministry of Finance ("MoF") provide "advice" on all significant actions by companies within their jurisdiction, even in the absence of express statutory authority.[30]

The use of guidance entails micro-management at its fullest. Guidance affects all banks and all practices. Under the philosophy of "no surprises," financial institutions inform the Ministry of Finance before taking any significant step.[31] Moreover, MoF rarely has to actually say no. Instead, the Ministry merely needs to suggest that the time is not right to go forward, tantamount to an order to abandon the matter.[32]

In the financial sector, the Ministry uses the process to oversee corporate policies, often with the goal of creating uniform,

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27. In Japanese, the phrase is *gyōsei shidō*.

28. Allan D. Smith, *The Japanese Foreign Exchange and Foreign Trade Control Law and Administrative Guidance: The Labyrinth and the Castle*, 16 LAW & POL'Y INT'L BUS., 417, 418 n.6 (1984); *see also* Yoriaki Narita, *Administrative Guidance*, 2 LAW IN JAPAN 45 (1968); Kenji Sanekata, *Administrative Guidance and the Antimonopoly Law*, 10 LAW IN JAPAN 65 (1977).

29. An illustration of this occurred in connection with the *tobashi* scandals in 1991. Brokers had secretly agreed to repay corporate clients for losses in the stock market. The Securities Bureau within MoF knew about the practice but did nothing to stop it. When the payments became public, a huge outcry ensued. MoF moved to penalize the securities firms. In an uncharacteristic burst of candor, the president of Nomura, Yoshihisa Tabuchi, stated at a shareholders meeting that the Ministry knew about the practice. Clay Chandler & Masayoshi Kanabayashi, *Japan's Securities Flap Clauses Tension Between Big Brokers, Finance Ministry*, WALL ST. J., July 1, 1991, at A10. Implicated, MoF suffered the consequences. The Finance Minister was forced to resign and legislation was passed to toughen the enforcement authority of MoF.

30. *See, e.g.*, Young, *supra* note 3, at 935 ("Thus, in Japan, agencies frequently attempt to accomplish through administrative guidance what by most admissions they cannot achieve under the governing legal regime.").

31. *See* BROWN, *supra* note 2, at 195.

32. Conversely, informal approval is tantamount to acceptance. Submission of a formal application amounts to a rote action, a final ritual.

industry-wide standards. Each category of banks has common hours of operations. Charges are uniform for withdrawals and the use of ATM machines.[33] Limits exist on advertising. Regulations also extend "as far as the establishment of energy conservation measures for banks, the encouragement of a five-day work week, and the provision of time off to permit bank employees to vote on election day."[34] Bureaucrats, therefore, remain intimately involved in the minutiae of industry affairs.[35]

Administrative guidance involves a highly personal form of regulation. Obtaining the requisite interpretative position requires constant interaction with the relevant *career* official within the relevant ministry.[36] Access to the appropriate bureaucrat, therefore, becomes critical to obtaining favorable rulings.[37] In the financial sector, officials from securities firms, banks and insurance companies travel to the Ministry daily, even twice daily, to keep MoF informed of their activities.[38] Banks and insurance companies bring matters to the attention of the Banking Bureau;

33. Japanese city banks all participated in BANCS, a system essentially linking all of their ATM machines together. The entire system and all of the participating ATM machines shut down at the same time each day, including all day Sunday. Citibank from the United States became the first financial institution in Japan to offer 24-hour-a-day ATM service. With only about 20 branches in Japan, however, this represented only a small convenience for consumers.

34. Young, *supra* note 3, at 937. Micro-management was not, of course, limited to the banking sector. *See* Hiroyuki Nishimura, *New Grads Face Reneging on Job Offers*, NIKKEI WKLY., Mar. 8, 1993, at 1, 27 (noting that the Ministry of Labor is putting pressure on employers not to renege on job offers).

35. The constant contact and lack of political oversight results in a close relationship between the bureaucracies and the industries they regulate. Not unique in Japan, similar claims have been made about independent agencies in the United States. *See* Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 426-27 (1990).

36. Each Japanese bureaucracy can be divided into career and non-career officials. Career officials are those who pass the higher civil service examination. Within each bureaucracy, they tend to be a small percentage of the total number of officials. In the MoF, for example, about 25 career officials join each year, with a total career population of around 600. The bulk of each bureaucracy consists of non-career officials. Despite their number and importance, non-career officials rarely obtain the top positions within the relevant ministry.

37. Foreign banks had difficulty gaining access to the relevant bureaucrats within the MoF, at least through the mid-1970s. Foreign officials typically interacted with the International Finance Bureau within MoF. The Bureau contained "barbarian handlers," those officials within the Ministry who could speak a foreign language and would interact with the foreign financial community in Japan. The Bureau, however, lacked substantive jurisdiction over banking and securities issues. Officials in the Bureau would, therefore, have to consult with the relevant substantive bureau within the Ministry of Finance for policy determinations. In the case of banks, that meant officials within the Banking Bureau. As a result, foreign banks ordinarily did not have direct contact with those officials actually making the decisions.

38. Each bank or company had a "MoF-*tan*", the person in charge of relations with the Ministry.

securities companies and investment advisors make the pilgrimage to the Securities Bureau.

The ability to impose informal or "administrative" guidance arises from a number of sources. Ministries play an active role in the legislative process. They, rather than the Diet, typically draft the laws they administer.[39] In drafting the laws, agencies tend to include few direct limits on their authority. The Diet therefore routinely adopts legislation containing only the broadest outline of a regulatory scheme, intentionally leaving the bureaucracy to fill in the gaps.[40] Legislative intent plays a much reduced role in creating limits to the discretionary authority of the bureaucracy.[41]

Most statutes are therefore vaguely worded and invite interpretation.[42] With the statutory scheme intentionally left vague,

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39. *See* John Owen Haley, *The Freedom to Choose an Occupation and the Constitutional Limits of Legislative Discretion*, 8 L. IN JAPAN 188, 189 (1975) (84% of Japanese legislation from 1951-65 was written by the relevant ministry). *See also* HIROSHI ODA, JAPANESE LAW 36 (1992) (noting that most laws are written by the bureaucracy). In part, the practice has a structural explanation. The Diet lacked the expertise and resources necessary to take a more active role. More importantly, however, allowing the bureaucracy to draft legislation had political advantages. The ministries had to first obtain a consensus on any regulatory shift. That often involved contentious debate and disagreement. *See infra* note 103. The Diet, therefore, preferred to leave this dispute resolution process to the bureaucracy.

40. While Congress also sometimes adopts vague statutes, bureaucratic latitude in Japan is much greater. In general, administrative agencies in the United States attempt to implement policies consistent with the intent of Congress. This often requires reference to legislative history, the value of which has generated a spirited debate. *Compare* Justice Scalia's opinion in Blanchard v. Bergeron, 489 U.S. 87 (1989) (Scalia, J., dissenting) *with* Judge Patricia Wald's views in *The Sizzling Sleeper: The Use of Legislative History in Construing Statutes in the 1988-89 Term of the United States Court*, 39 AM. U. L. REV. 277 (1990). Japanese administrative agencies have much more latitude. By including broad statutory provisions, the Diet allows the bureaucracy to form a consensus among affected interest groups. *See* discussion *infra* part I.C. Provisions that are too specific or too restrictive might impede the consensus building process. The Diet, therefore, intentionally transfers discretion over policy determinations to the relevant administrative agency. This suggests that the Supreme Court's analysis of legislative intent to transfer to the bureaucracy the authority to interpret ambiguous provisions applies more accurately to Japan. Chevron v. Natural Resources Defense Counsel, 467 U.S. 837, 843 (1984) ("The power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.").

41. That does not suggest an absence of political constraints, however. *See infra* part I.B.1.

42. One commentator described the Japanese law as "extremely broad and aspirational; it creates no legal duties on the part of government agencies and no new legal rights for individuals." UPHAM, *supra* note 26, at 86. Vague laws and broad bureaucratic discretion have long been recognized. *See* REP. OF THE MISSION ON JAPANESE COMBINES, Mar. 1946, at 53 ("Japanese financial laws follow a common pattern. They prescribe certain general standards with respect to the institutions they purport to regulate and vest absolute power in the Minister of Finance to define, alter, and enforce the standards. In reality, they place no serious limitations

the task of filling in the gaps is left to the bureaucracy in consultation with the affected industries.[43] The affected companies generally accept the bureaucracy's interpretations because of both the benefits attendant with close government oversight and the desire to avoid the ire of an offended bureaucracy.[44]

The system leaves little recourse in the event of an unfavorable ruling. Appeal can be made to higher ranking Ministry officials within a particular bureau. Attempts to send matters "upstairs," however, occurs infrequently.[45] In addition to a minimal likelihood of success, appeal to higher ranking officials confronts a more practical impediment. Even low-ranking officials ultimately rise to high-level positions within the bureaucracy and are not likely to forget past slights.[46]

The personal nature of the decision and rapid rotation within the Ministry do provide one mechanism for redress.[47] After receiving an adverse ruling, financial institutions often wait until the official changes and then bring the issue up again, with slightly altered facts. The change in facts essentially creates the

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upon the minister's power."). This phenomenon is not accidental. Japanese politicians benefit by shifting tough issues to the bureaucracy, and the bureaucracy benefits through enhanced authority.

43. Even in the United States, the presence of vaguely worded provisions can act as a limit on judicial review. Courts have long recognized that parties cannot sue over agency inaction where Congress has imposed no clear parameters. *See* Heckler v. Chaney, 470 U.S. 821 (1985).

44. Oriented toward stability, regulators tended to restrain competition. In the financial sector, for example, MoF issued almost no new banking licenses in the post-war era. The only exceptions were licenses for a handful of trust banks and two additional long term credit banks. MoF also minimized competition by resolutely maintaining the barriers dividing financial institutions. For an historical overview of the compartmentalized banking system, see J. Robert Brown, Jr., *Japanese Banking Reform and the Occupation Legacy: Decompartmentalization, Deregulation, and Decentralization*, 21 DENV. J. INT'L L. & POL'Y 361 (1993). Banks and brokers, therefore, accepted a high degree of regulation in return for guaranteed market share.

45. Hesitancy to confront the bureaucracy arises for a number of reasons. First, the process is often slow. Officials within the relevant bureaucracy study new issues interminably, essentially trying to assess the consequences of any policy change. To do otherwise could harm a bureaucrat's career. *See infra* note 92. Approaching bureaucrats may also result in a loss of secrecy. Government officials often seek advice from others within the affected industry in assessing a new policy, thereby publicizing the initiative before implementation. Finally, the matter, to the extent approved, will typically be extended to all industry participants. This will destabilize the existing equilibrium, creating new winners and losers. All of these factors discourage individual companies from seeking regulatory reform.

46. As in bureaucracies everywhere, higher ranking officials in MoF are loathe to overturn decisions of their subordinates. More directly, however, the need for a consensus means that these officials are informed in advance of any significant interpretation. They had therefore already acquiesced to the decision. In those circumstances, the likelihood of a reversal is not great.

47. MoF officials generally rotated on an annual basis. BYUNG CHOL KOH, JAPAN'S ADMINISTRATIVE ELITE (1989).

appearance of a new matter. This allows the successor within the Ministry to accept the position while avoiding the appearance of reversing his predecessor.[48]

Rare exceptions aside, the views of the bureaucrats are the last word on the matter.[49] Japanese businesses do not rely on the courts for redress when unhappy with administrative policies.[50] To some degree, the explanation is cultural, particularly the desire to avoid the public disharmony associated with litigation.[51] To some degree, the explanation is more practical—too few lawyers and judges and an unsympathetic court system.[52] More directly, however, litigation would irritate the bureaucracy and,

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48. The use of the masculine possessive pronoun here was no accident. While some ministries have allowed women to reach relatively high positions, particularly the Ministry of Foreign Affairs, this has not been true at the Ministry of Finance. Career women have barely reached the level of *kachō*, or division director within a bureau. *See And Mrs. National Property*, ECONOMIST, July 1, 1989, at 64 (noting appointment of first woman to position of *kachō* within Ministry of Finance).

49. These policies also have an aura of credibility arising out of the high regard placed on the bureaucracy within Japan. The career bureaucracy represents an elite and includes graduates from the best Japanese universities. Typically viewed as above the political fray, the bureaucracy has been looked upon as the guardian of the national interest.

50. Litigation in most instances would be far less effective than other means of obtaining redress. Industries overseen by the bureaucracy ordinarily have a direct role in the formulation of regulatory policy. At a minimum, they can usually prevail upon MoF to acknowledge their interests and moderate any proposed change. Businesses, therefore, often gain more by working within the system rather than resorting to court challenges. The courts would seem more appealing for excluded groups such as consumers. Consumers, however, have not historically been well organized and, in any event, have had a deferential attitude toward the bureaucracy.

51. In other words, Japan is a country where "the Confucian ideals of social harmony and antipathy toward law have been internalized by a loyal and cooperative population." UPHAM, *supra* note 26, at 1. *See also* Lynn Berat, *The Role of Conciliation in the Japanese Legal System*, 8 AM. U. J. INT'L L. & POL'Y 125, 150 (1992). Some disagree with the characterization of Japan as a nonlitigious society. *See* John Owen Haley, *The Myth of the Reluctant Litigant*, 4 J. JAPANESE STUD. 359 (1978).

52. *See* Harold See, *The Judiciary and Dispute Resolution in Japan: A Survey*, 10 FLA. ST. U. L. REV. 339 (1982) (noting that Japan had one judge per 39,028 people, compared with one judge per 3,502 people in Germany); *see also* Takaaki Hattori, *The Role of the Supreme Court in Japan in the Field of Judicial Administration*, 60 WASH. L. REV. 69 (1984) (noting that in Japan, judges have been criticized as "fossils" or "greenhorns far removed from the rough and tumble of life in the street and therefore prone to hand down judgments that are out of touch with the world."). These numbers suggest an obvious consequence: delay. *See* ODA, *supra* note 39, at 79 ("The Japanese Court system is notorious for its delays. In civil cases in 1990, the average length of a trial was 11.9 months in the district court and 13.2 months in the appellate court, and 3.1 months even for summary courts. Of 1,376 cases pending at the Supreme Court, there were 211 cases where it had taken more than 10 years after the case was brought to court.").

potentially, have collateral consequences on future decisions by government officials.[53]

2. *Amakudari*

The system of regulatory control receives further strengthening through *amakudari*, or "descent from heaven."[54] Following retirement, rafts of retired government officials disperse throughout the financial system. Partially driven by necessity, paltry pensions make second careers essential. Officials retire around age 55, with a good 10 years of service remaining.[55] In effect, they receive high level sinecures as a reward for longstanding public service.[56]

Among Japanese bureaucracies, the Ministry of Finance consistently proves the most successful at obtaining positions for retiring officials. They go to a variety of entities, including government-affiliated financial institutions, public corporations, private companies, and accounting firms.[57] Regional and trust banks all routinely accept the officials.[58] So do trade associations, stock exchanges, and research institutes for securities companies. Former administrative vice ministers, the highest career position within MoF, monopolized a number of critical posts, in-

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53. Under the Banking Law, for example, a bank had to obtain a license not only to open but also to close or move branch offices. For a discussion of the authority, see *The Banking System In Japan*, FED'N OF BANKERS ASS'N OF JAPAN, 1989, at 41. The Law contained no standards, leaving the decision entirely up to the discretion of the Ministry of Finance. Banks knew that antagonizing MoF or otherwise resisting government guidance in other areas could limit the approval of branch applications.

54. The word illustrates the high regard generally placed on the bureaucracy in Japan. Officials undergoing *amakudari* typically obtain a higher profile, higher paying job. Nonetheless, this is viewed as a descent from the prestigious perch of the bureaucracy.

55. Of those government officials retiring in 1989, the average age was 55.6. *The One-Way Revolving Door: MoF Officials Lead in Getting Related Private-Sector Jobs*, Comline Daily News Tokyo Financial Wire, Mar. 29, 1990, *available in* LEXIS, World Library, TOKFIN File.

56. The Ministry's Secretariat has the responsibility for finding employment for retired officials. In 1993, 208 career bureaucrats "descended from heaven," with the largest number, 64, from MoF. The Construction Ministry was second with 22. *Japan Civil Servants Continue "Descent from Heaven" to Industry,* Reuter Business Rep., Mar. 24, 1993, *available in* LEXIS, World Library, Reubus File.

57. KOH, *supra* note 47 at 239.

58. KOH, *supra* note 47, at 239-40 (noting that class of 1984 sent one Ministry official to Mitsui Trust Bank while the class of 1986 sent one to Mitsubishi Trust Bank). Among regional banks, the Bank of Yokohama and Bank of Hiroshima routinely accept retiring Ministry officials. In entering a bank, Ministry officials typically served first as advisor and eventually director. Both the Bank of Japan ("BoJ") and MoF fought hard to find and maintain banks that would take their retiring officials. Ministry banks included the Bank of Yokohama, Hiroshima Bank and Hokkaido Bank. BoJ banks include Chiba, Kanto, Shiga, Fukuoka, Awa, and Sanin Godo. *A Retiring Riddle from Japan*, ECONOMIST, June 23, 1990, at 82.

cluding President of the Tokyo Stock Exchange, Chairman of the Asian Development Bank, and Chairman of the Export-Import Bank.[59]

Amakudari also solidifies MoF's control over other government agencies. Ministry officials routinely serve as Governor of the Bank of Japan.[60] Similarly, a retired career official usually acts as chairman of the Federal Trade Commission, the only "independent" agency within the Japanese bureaucracy.[61]

Not all financial institutions accept the retiring officials. In particular, the large commercial (city) banks refuse to do so. Proud, with long histories, these financial institutions have been almost militant in resisting the descending officials.[62] Accepting a single official, it was feared, would create the expectation of future descents: Better not to open the door.[63]

In the securities sector, the descent from heaven usually means positions with the stock exchanges, trade associations, and think tanks.[64] These include:

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59. *See infra* note 65; *see also Tarumizu to Be Next ADB President, MoF Source Says*, Japan Economic NewsWire, Apr. 26, 1989, *available in* LEXIS, World Library, JEN File.

60. With one exception, all governors in the post-war era have alternated between a retired career official from MoF and an official from the central bank. *See* J. Robert Brown, Jr., *Toward a More Independent Central Bank*, ASIAN WALL ST. J., Mar. 8, 1993, at 10.

61. *New Japan FTC Head to Seek Antitrust Transparency*, Reuter Fin. Rep., Sept. 24, 1992, *available in* LEXIS, World Library, REUFIN File (noting that four successive chairmen of FTC had been retired officials from MoF).

62. This was particularly true of the former zaibatsu banks, Fuji, Sumitomo, Mitsui and Mitsubishi. Dai-Ichi, the oldest commercial bank in Japan, also refused to accept the retiring officials. Other city banks, however, had less objection. Until the merger with Mitsui, every president of Taiyo Kobe Bank—a bank formed in 1973—had been a retired career official from MoF. *See Appointments*, JAPAN ECON. J., June 13, 1987, at 4. Similarly, the Bank of Tokyo ("BoT") represented another exception, having had a central bank or Ministry official in a policy position since the occupation. Yusuke Kashiwagi, the former vice minister of international affairs, even rose to the rank of president and then chairman of the bank. In conversations, however, BoT officials often minimized the connections. They noted that Kashiwagi's father had served as a director to BoT's predecessor bank, the Yokohama Specie Bank. Officials at the bank, therefore, tended to consider him not entirely a former government official but rather someone with longstanding ties to the bank.

63. In the 1980s, Sumitomo Bank took a descending Ministry official, something considered a great coup at the time. The experiment did not work out, however, and was not repeated.

64. In general, retiring officials have no history of descending directly into the securities firms, although rare exceptions do occur. *See* Naoyuki Isono, *Regulators and Regulated: Some Ties That Bind*, NIKKEI WKLY., July 6, 1991, at 4 (noting that Sadao Hashimoto, former director general of the printing bureau within MoF, had become president of Yamatane Securities).

1. President of the Tokyo, Osaka, and Nagoya stock exchanges;[65]
2. President of the Japan Securities Investment Advisors' Association;[66]
3. Chairman of the Capital Market Promotion Foundation;[67]
4. President of the Capital Market Research Institute;[68]
5. President of the Nomura Research Institute;[69]
6. President of the Tokyo International Financial Futures Exchange;[70]
7. Vice Chairman of the Japan Securities Dealers Association;[71] and
8. Vice President of the Trust Companies Association.[72]

Financial institutions benefit from the presence of the retired officials by obtaining important government contacts and by receiving insight into government thinking on a variety of issues. MoF also benefits. Retired officials receive attractive positions, which facilitates recruitment into the bureaucracy and creates a fifth column of supporters throughout the financial sector. The merger of Taiyo and Kobe banks in 1973 represented an example of a development aided by *amakudari.* Both banks were headed by retired MoF officials and merged at a time when MoF was promoting increased consolidation in the banking sector.[73]

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65. *Nagaoka Expected to Head Tokyo Stock Exchange*, JAPAN ECON. J., Apr. 23, 1988, at 10 (listing four former vice ministers that headed TSE—Minoru Nagaoka, Michio Takeuchi, Hiroshi Tanimura, and Teiichiro Morinaga).

66. Hiroshi Yonesato, a former director general of the Banking Bureau, became the first president in 1987. *See Yonesato Chosen to Head Securities Body*, JAPAN ECON. J., Oct. 31, 1987, at 6.

67. *See* Henny Sender, *How Turf Wars Did In Financial Reform*, INST. INV. INT'L ED., June 1991, at 82 (noting Capital Markets Promotion Foundation was headed by former Vice Minister of MoF, Hiroshi Tanimura).

68. *See* Yuko Mizuno, *MoF Rules Through "Old-Boy" Net*, JAPAN ECON. J., Sept. 8, 1990, at 32 (noting that Capital Market Research Institute was headed by former Vice Minister of MoF, Michio Takeuchi).

69. *Id.* (noting that Nomura Research Institute was headed by former director general of Banking Bureau within MoF, Hiromi Tokuda).

70. Taroichi Yoshida, the first president of the Tokyo Financial Futures Exchange, had served as Vice Minister for International Affairs in the Ministry of Finance. *See* Kenneth Klee, *Taroichi Yoshida's Future Plans*, INST. INV. INT'L ED., Apr. 1989, at 11.

71. The position of chairman had historically rotated among the Big Four, Nomura, Daiwa, Nikko, and Yamaichi. Following the *tobashi* scandals, *see supra* note 29, MoF tried to force Michio Takeuchi, a retired Ministry official, in as chairman. The industry successfully resisted the effort. In 1992, however, Tokyo Securities chairman Sakae Kudo became chairman of the Association, breaking the hold of the Big Four.

72. *See* Mizuno, *supra* note 68, at 32 (noting that Kyoji Kitamura, former director general of the Securities Bureau in MoF, was appointed as vice president of Trust Companies Association).

73. *See Bank Merger Background*, COMLINE News Service, Sept. 1, 1989, *available in* LEXIS, World Library, TOKFIN File.

3. *Limits*

The description of bureaucratic influence often creates the appearance of an omnipotent regulator. Legislation imposes few constraints. Politicians rarely intervene directly in administrative affairs.[74] Judicial review largely does not exist. This lack of limits suggests regulation by fiat.

In reality, however, MoF's authority is far from open-ended. Limits do exist. Policy changes are not "whimsical," but are preceded by the careful development of a *consensus* on the nature and direction of change.[75] To the extent that vehement disagreement exists over policy shifts within an affected industry, the Ministry has little ability to force the changes. Attempts to do so would damage credibility and the likelihood of compliance.[76]

Policy changes, therefore, are preceded by a process of notice and comment, although very different from what is done in the United States. Major policy changes require consensus building within the affected industries.[77] Views are solicited; disagreements considered. Rather than employ a formal notice and comment process, however, MoF relies on personal contact.[78]

MoF uses daily contacts with brokers and banks to learn what is going on in the market and to obtain feedback on the impact of various regulatory proposals.[79] Less inclusive and far more personal than what occurs in the United States, the process does not include the full spectrum of Japanese interest groups.[80]

74. The two highest profile examples of political intervention prove the point. As the minister overseeing MITI, Masayoshi Ohira publicly intervened to prevent the promotion of the person designated to become administrative vice-minister. JOHNSON, *supra* note 2. More recently, the minister of MITI again blocked an expected promotion to the position of administrative vice-minister. *See* Hiroshi Nakamae, *Forced Resignation Shakes up Bureaucrats*, NIKKEI WKLY., Dec. 27, 1993, at 4.

75. Matsuura, *supra* note 21, at 1637.

76. The need for a consensus also applies to other bureaus and ministries affected by the policy. *See infra* note 103. As one commentator put it: "In key ministries in the Japanese government, the best human resources and information about the industries are pooled together. It is natural then that the real power struggle takes place there, in the very heart of the power structure in Japan." John H. Jackson et al., *Implementing the Tokyo Round: Legal Aspects of Changing International Economic Rules*, 81 MICH. L. REV. 267, 302 (1982).

77. In Japan, the concept of consensus does not suggest complete agreement. Instead, consensus occurs when no significant group continues to object to the change.

78. MoF also uses a system of councils to obtain comments, although with less effect. For a description of the process, see JAMES HORNE, JAPAN'S FINANCIAL MARKETS 153-62 (1985).

79. In some respects, therefore, MoF uses the contacts as a Japanese substitute for notice and comment required under the U.S. APA. 5 U.S.C. §§ 551-57 (1988).

80. As one commentator noted: "The first and possibly the most important step in consensus building is the careful selection of a group of people to be invited to the

The need for consensus means that the relevant Ministry of Finance bureau remains a captive of industry.[81] MoF also has to act within political constraints.[82] On one hand, the Ministry jealously guards its independence from direct political intrusion. Bureaucrats, not politicians, determine specific policies and write legislation. MoF, not the Diet, determines the government's annual budget.[83] Politicians rarely intervene directly, having little input into promotions within the bureaucracy.[84]

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discussion table." Matsuura, *supra* note 21, at 1634. Consumer groups have generally not been well represented in the policy process. *See MoF Concerned About Further LDP Intervention in Financial System*, COMLINE, May 17, 1991, *available in* LEXIS, Nexis Library, COMLINE File (discussing LDP paper that criticized MoF for not sufficiently addressing interests of consumers). MoF would, of course, disagree with the characterization. One official at the Ministry stated that consumers had no need for express representation because all MoF officials, as members of the middle class, represented their views. Interview with Official from Ministry of Finance (Mar. 1992).

81. *See* DANIEL I. OKIMOTO, BETWEEN MITI AND THE MARKET 15 (1989) (noting that government regulatory policies did not result from unilateral decree but through "consultation, consensus, and voluntary compliance."); *see also* Young, *supra* note 3, at 923 ("The attributes that permit an agency to intervene in a variety of areas also strictly limit the form that intervention can take and circumscribe the degree to which the agency may actually intrude and attempt to order affairs."). Reflecting this reality, the Ministry of Finance adopted a number of expedient practices for treatment of banks. For most of the postwar era, MoF essentially treated the top tier of Japanese city banks identically. Within the top tier, international expansion and increases in lending tended to be uniform. The Ministry knew that any disparity would generate a revolt.

82. In many respects, the Japanese bureaucracy and independent agencies in the United States have common characteristics. The peculiar position of independent agencies makes them less beholden and, concomitantly, less accountable to the Executive Branch. With less "political" accountability, independent agencies become more susceptible to industry influence. *See* Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 426-27 (1990).

83. The best English-language account of the role of MoF in the budgetary process can be found in JOHN C. CAMPBELL, CONTEMPORARY JAPANESE BUDGET POLITICS (1977). At least one Japanese source has examined the Budget Bureau, although emphasizing the internal machinations of the Bureau rather than the budgetary process itself. *See* YOSHIMITSU KURIBAYASHI, ŌKURA-SHŌ SHUKEI-KYOKU [THE BUDGET BUREAU OF THE MINISTRY OF FINANCE] (1986).

84. The independence had a number of practical explanations. Through much of the postwar era, the Diet lacked the staff necessary to obtain expertise in areas such as banking and finance. Thayer, in his seminal work, noted that "[t]he great power of the bureaucrats is their control of information." NATHANIEL B. THAYER, HOW THE CONSERVATIVES RULE JAPAN 228 (1969). Moreover, finance ministers typically served for only a year or two, hardly enough time to gain control and impose policies. *Id.* at 203. *See also* CAMPBELL, *supra* note 83, at 151 (explaining the lack of influence of the cabinet over the budget process; "[f]undamentally, because it is more an aggregation than a real institution: its membership turns over every year or so (sometimes every six months), and ministers are normally much more concerned with their individual political affairs than with advancing the Cabinet as such.").

On the other hand, MoF remains conscious of political constraints.[85] The absence of direct involvement serves the politicians' interests. The Diet lets MoF arbitrate contentious and controversial issues while it stays above the fray.[86] MoF has the task of achieving a consensus within the affected industries as to the proper plan for reform. This involves intensive discussions and lobbying.[87] Given this slow process, the Diet has little interest in tampering with the final results.[88]

MoF, therefore, has relatively free reign only because it is proficient at achieving consensus on the direction of reform without conflicting with the broad political goals of the Diet.[89] To the extent MoF fails to operate within these constructs, political intervention is more likely.[90]

These limitations have practical effects. The need for consensus and the parameters established by politicians means that the bureaucracy rarely embarks on bold, novel initiatives. Instead, they tend to implement change incrementally, on a "step-

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85. This was also particularly true in connection with the drafting of the annual budget. *See* CAMPBELL, *supra* note 83, at 140 (while politicians do not ordinarily interfere at the macro-level in the development of the budget, "MoF's anticipation of party reactions are influential in framework-setting and do significantly 'distort' budgeted priorities away from MoF preferences . . . .").

86. FRANCIS MCCALL ROSENBLUTH, FINANCIAL POLITICS IN CONTEMPORARY JAPAN 26-27 (1989) ("Indeed, the LDP shows a strong preference for delegating to MOF delicate balancing operations between Japanese banks and their rivals, the securities houses, for fear of alienating either group.").

87. As one author concluded, "The Japanese bureaucracy does not dominate, it negotiates." RICHARD J. SAMUELS, THE BUSINESS OF THE JAPANESE STATE: ENERGY MARKETS IN COMPARATIVE AND HISTORICAL PERSPECTIVE 26 (1987). While largely true, this ignores a variety of coercive measures that MoF can sometimes use to induce consensus.

88. Achieving a consensus means that MoF has to include in the deliberative process all affected interest groups. To the extent they are excluded, groups would have reason to go to the Diet for changes. MoF has recognized this and proved adaptive. While forging consensus within industry, MoF historically excluded certain groups, most noticeably consumers. *See* Young, *supra* note 3, at 947. Not particularly well organized or vocal, consumers made little trouble for MoF among politicians. As that began to change, however, MoF started to bring consumers into the deliberative process. When a commission was formed to discuss reform following certain scandals in 1991, MoF for the first time appointed consumer groups as members.

89. Failure to obtain the requisite consensus could result in political intrusion. *See* Young, *supra* note 3, at 947. In the finance area, this occurred in connection with the 1980 reforms to the Banking Law. Banks felt that the changes went too far in accommodating the interests of securities firms and unsuccessfully appealed to politicians. *See* ROSENBLUTH, *supra* note 86. Inter-ministry conflict represented another basis for political intervention.

90. *See* BROWN, *supra* note 2, at 138-39. MoF officials had another reason for respecting political boundaries. Many went on to successful political careers. In the postwar era, four Prime Ministers, Ikeda, Fukuda, Ohira, and Miyazawa, all had careers in MoF before becoming politicians.

by-step" basis.[91] They also tend to react hesitantly to change, preferring a conservative approach to innovation.[92]

II. THE JAPANESE ADMINISTRATIVE STATE AND THE REGULATION OF ADVERTISEMENTS BY INVESTMENT ADVISORS

The regulation of investment advisors illustrates the functioning of the Japanese administrative state. Personal contact between regulators and regulated predominates. Informal positions abound. *Amakudari* is prevalent, particularly in the relevant trade associations.

The Ministry of Finance supervises investment advisors. Oversight rests with the Investment and Management Division of the Securities Bureau.[93] As a practical matter, however, MoF has delegated oversight of advertisements to the ten Financial Bureaus.[94] These are local Ministry offices scattered throughout Japan.

In regulating the financial markets, MoF often relies on trade associations to implement policies.[95] The Japan Securities Investment Advisors Association ("JSIAA") acts as a self regula-

91. Contrast this with the situation in the United States. When the presidency changed parties in 1980, efforts were made to alter regulatory policies. In some circumstances, the changes were dramatic. *See, e.g.*, Rust v. Sullivan, 497 U.S. 1002 (1991). In *Rust*, the plaintiffs argued that the sudden and dramatic change in regulations concerning the federal funding of family planning programs was a basis for greater judicial scrutiny. The Supreme Court disagreed.

92. The conservative attitude arises not only from the need to develop a consensus but from conventional bureaucratic behavior. Bureaucratic officials move up the hierarchy in lockstep until their mid-to-late 40s. Thereafter, the pyramid narrows, with fewer receiving promotions. To the extent an official becomes involved in a scandal or embarrassing incident, upward advancement stops. *See* Henny Sender, *Here Comes Makoto Utsumi*, INST. INV., Aug. 1989, at 31 (discussing how Utsumi's career almost ended when he became involved in unpopular efforts to prevent tax evasion on certain types of savings accounts). New policies that deviate significantly from the tried and true pose risks. If the approach does not work or proves embarrassing, the official's career founders. Bureaucrats, therefore, consider matters interminably and prefer incremental, less risky shifts.

93. In Japanese, *gyōmu-ka tōshi-kanri-shitsu*.

94. The Minister of Finance is authorized to delegate authority to the Director or Assistant Director of the Financial Bureaus. Cabinet Order No. 333 of Oct. 28, 1986, art. 11; Law for Regulating Securities Investment Advisory Business, art. 51, (Law No. 74 of May 27, 1986) [hereinafter SIAL].

95. Trade associations often have close relationships with the relevant regulator. MoF, in particular, uses trade associations to implement government policies. Associations essentially apply collective pressure to ensure conformity with regulatory policies. As one commentator noted: "A company must expect an antagonistic reaction from the trade association if it stubbornly opposes the measures proposed and supported by the majority." Matsuura, *supra* note 21, at 1634.

tory organization for advisors.[96] Typical of trade associations, the JSIAA has maintained a close relationship with MoF, with its first president a retired official from the Banking Bureau.[97]

The Association has adopted comprehensive rules governing advertisements.[98] These rules essentially fill in gaps in the statute and in the interpretations issued by MoF. The rules specifically disclaim any intent at content regulation, although as a practical matter the vagueness of some of the provisions effectively limits what advisors can say.

A. BACKGROUND

Advisors as significant players in the Japanese financial markets are a relatively recent phenomena. Despite a long history in Japan, they amounted to a relatively insignificant eddy. Largely unregulated and limited to investment advice for individuals and the management of *tokkin* accounts, advisors were excluded from the most profitable areas of operation—pension plan and mutual fund management.[99] Mutual funds had to be run by an investment trust manager; pension plan assets were managed exclusively by trust banks and insurance companies.[100]

Things began to change in the latter half of the 1980s. In reaction to financial scandals, the Diet adopted the Securities Investment Advisory Law in 1986, comprehensive legislation designed to regulate advisors.[101] Shortly afterwards, advisors received authority to manage pension plan assets, although with limitations. Only "new money," or contributions received after April 1990, could be managed by advisors and only in connection

96. The Association was formed in 1987, a year after the adoption of the SIAL. A separate association exists for the mutual fund industry, the Investment Trusts Association of Japan.

97. *See supra* note 66. The SIAL codifies the relationship between MoF and the JSIAA. MoF has the authority to require the Association "to cooperate with the Minister in the submission and filing of such documentary evidence and with respect to such other necessary matters which are required to be submitted, filed or provided under the provisions of this law." SIAL, *supra* note 94, at art. 45.

98. Japan Securities Investment Advisors' Association, *Self-Regulations Concerning Advertising and Canvassing*, *reprinted in* 2 TŌSHI KŌMON [Investment Advising] (1988) [hereinafter *Self-Regulations*].

99. *Tokkin* accounts were off-balance sheet funds used by corporate Japan in the 1980s to engage in stock speculation. When the stock market collapsed in 1991, so did *tokkin* accounts. The disappearance of the *tokkin* business forced Japanese and foreign advisors to look for alternative sources of business, with the pension area the most obvious source.

100. *See* THE JAPANESE FINANCIAL SYSTEM 86-87 (Yoshio Suzuki ed., 1992). Affiliates of Japanese securities firms have historically dominated the area. This has begun to change with the entry of four foreign firms and indications from MoF that banks and insurance companies will gradually be allowed to operate in the area. Yas Idei, *Investment Trust Access Disappoints Banks*, NIKKEI WKLY., July 11, 1992, at 17.

101. SIAL, *supra* note 94.

with plans in existence for at least eight years. Advisors could manage no more than one-third of a plan's assets.[102] The limits had a territorial explanation; efforts by advisors to obtain increased business necessarily meant a loss of market share for trust banks and insurance companies.[103]

With advisors easing into pension plan management, obtaining business became a matter of concern. Typical of Japan, attracting clients was mostly a matter of personal contacts and preexisting business relationships. Companies tended to favor insurance companies and trust banks within their industrial group, or *keiretsu*.[104] To the extent they turned to advisors, they favored those affiliated with their lead bank or principal underwriter.[105]

The need for personal contacts and relationships minimized the benefit of indiscriminate marketing campaigns. Advisors, therefore, had little incentive to advertise. As a result, they

102. Material provided by the American Chamber of Commerce in Japan, June 1993 (on file with the author). MoF has indicated that it will eliminate the distinction between new and old money. The other restrictions, however, will apparently remain in place. The eight year requirement disproportionately impacts foreign advisors. Their natural clientele includes foreign companies operating in Japan. With most foreign companies new to the country, they cannot assign assets to advisors (foreign or domestic) because of the eight year requirement.

103. The struggle over an increased role for advisors has not been limited to the private sector but also has a bureaucratic component. Within MoF, the Banking Bureau opposes policies likely to hurt trust banks and insurance companies, entities under its purview, while the Securities Bureau favors increased business for advisors, entities it regulates. In addition, the funds placed with trust banks have been a useful tool for the Ministry. When the stock market collapsed in 1990, reports indicated that the Ministry of Finance had tried to stem the decline by providing additional pension money to trust banks to promote the purchase of shares. A reduction in the funds handled by trust banks would reduce the potency of this device. *See* Shigeru Wada, *Public Trust Funds Restrained in Market*, NIKKEI WKLY., Jan. 31, 1994, at 13. Conflicts also exist among the ministries. MoF has opposed rapid reform while the Ministry of Health and Welfare, which oversees the employee pension funds, has favored increased asset management flexibility.

104. The *keiretsu* are industrial groups within Japan. For a discussion of the *keiretsu*, see generally Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993). Companies routinely assign management responsibilities based on relationships rather than performance. Business stays within the group, creating barriers for others, including foreign firms. Japan has no ERISA-type provision requiring companies to manage assets in a "prudent" fashion. Unlike the United States, therefore, Japanese companies can pick advisors based on relationships rather than advisor performance.

105. Moreover, little price competition existed among banks and securities firms. Each essentially provided a guaranteed return, with little variation among the entities. Particularly during a period of falling stock prices, trust banks and insurance companies could maintain the guaranteed return only through accepted, but questionable, accounting legerdemain. *See infra* note 135.

rarely resorted to the mass media to advertise their services.[106] While they did use brochures and information statements, indiscriminate distribution in Japan generally did not occur.

Matters in Japan are, however, evolving. As the country's population continues to age, the need to fund retirement plans adequately has become increasingly important. Japanese companies have, therefore, gradually begun to focus on advisor performance.[107] Advisors with unique expertise or exemplary performance will become more attractive. To publicize these advantages, advisors will, in the future, turn increasingly to advertising. To the extent the government maintains a restrictive approach to advertising, the most disadvantaged advisors will be those with unique quantitative advantages, but without widespread personal contacts, characteristics prevalent within the foreign advisory community.

B. The Regulatory Scheme

As in the United States, advisors are subject to a comprehensive regulatory scheme. Under the Securities Investment Advisory Law,[108] advisors must register with the Ministry of Finance to receive a limited, non-discretionary license.[109] Obtaining a discretionary license—something necessary to manage pension

106. In one study commissioned by an American advisor, no advertisements for investment advisory services were found in any of 108 newspapers and 176 magazines over the last five years.

107. *See, e.g.*, Yas Idei, *Pension Funds Look for Performance*, NIKKEI WKLY., July 18, 1993, at 19. The trend should not, however, be overstated. First, because of the strength of preexisting relationships, existing pension funds are not likely to be moved from trust banks and insurance companies. Second, the Japanese, at least anecdotally, seem highly risk averse. They may therefore be less willing to place funds with advisors that have attractive records but higher risk. Finally, a whole host of changes in the process of computing performance must occur to achieve true comparability. *See infra* note 135.

108. The law became effective on November 25, 1986. The Capital Markets Research Institute has translated the original law into English. The translation does not, however, include amendments adopted in 1988 (Law No. 75 of 1988) or 1993 (Law No. 87 of 1993).

109. SIAL, *supra* note 94, at art. 5. Registration poses few difficulties. Advisors file the requisite application and MoF enters their name in a registry and assigns a registration number. *See id.* at art. 7. Obtaining a discretionary license, however, is a more significant proposition. Advisors with discretionary licenses have much greater investment authority, including the right to manage assets for employee pension funds. A discretionary license requires Ministry approval. *Id.* at arts. 24-27. To obtain approval, the advisor must meet stringent standards including at least 100 million in capital, 20 billion in assets under management and the expectation of profits in three years. Letter from Denver Investment Advisors, Inc., to Mr. David Hale, Senior Vice-President, Chief Economist, Kemper Financial Companies (Nov. 2, 1993) (on file with author).

plan assets—involves a more laborious process, requiring express approval.[110]

The Act contains a number of substantive limitations on operations. Advisors cannot trade in the shares they recommend.[111] They cannot act as depositories for cash or securities[112] and cannot make loans to customers.[113] They are prohibited from engaging in "fraudulent, deceptive or manipulative" acts or practices in connection with the execution of an advisory contract,[114] from providing "unfounded advice,"[115] and from offering to bear losses or provide additional profits to induce customers to purchase or sell securities.[116]

Advisors are also subject to affirmative disclosure requirements. They must post a sign at each place of business "in accordance with the form prescribed by an ordinance of the Ministry of Finance."[117] Before executing an advisory agreement, advisors must provide customers with information, particularly about remuneration and limitations on activities.[118] They must provide additional information at the time of execution.[119] Customers also receive updated information every six months.[120]

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110. *See* SIAL, *supra* note 94, at art. 24-33. According to one advisor operating in Japan, the process included the submission of a floor plan specifying the office location of each employee and the location of the company's safe. The dichotomy between registration and licensing enhances bureaucratic authority. The registration process seems relatively straightforward, requiring advisors to simply file the requisite information before beginning operations. As a practical matter, however, registration requires consultation with, and preclearance by, the Securities Bureau. Failure to do so might antagonize the bureaucracy, something likely to be remembered whenever the advisor seeks a discretionary license. A similar dichotomy exists in the banking area between representative offices and branches.

The requirements imposed by MoF make discretionary licenses prohibitively expensive for many foreign advisors. MoF requires them to have a permanent office, something that can cost around $1 million for even skeleton facilities. In addition, a foreign company must have at least 100 million ($960,000) in the country as capital. Advisors must be prepared to absorb these costs even before they obtain an appreciable amount of business, a long term proposition at best. *See* BROWN, *supra* note 2.

111. SIAL, *supra* note 94, at art. 18.

112. *Id.* at art. 19.

113. *Id.* at art. 20.

114. *Id.* at art. 22(1).

115. *Id.* at art. 22(2).

116. *Id.* at art. 23.

117. *Id.* at art. 11. The sign must be visible to the public and be of sufficient quality as to be "capable of extended use." Release No. FM-1914 from Director General of the Securities Bureau, MoF, to the Directors General of the Financial Bureaus, Nov. 17, 1986.

118. SIAL, *supra* note 94, at art. 14.

119. *Id.* at art. 15.

120. *Id.* at art. 121. The advisor has record keeping responsibilities, including the retention of records concerning performance and records "relating to the advice" given customers. The records must include the advice given, the performance data

The statutory framework provides MoF with exceedingly broad discretion. For example, in issuing a discretionary license the Law authorizes the Ministry to attach any terms and conditions deemed "necessary for the protection of investors."[121] Similarly, MoF must approve any change "in the nature and method" of the business of an advisor with a discretionary license.[122] Both provisions give MoF considerable latitude to intrude into the ordinary business operations of an advisor.

MoF has taken advantage of the authority to remain actively involved in the oversight of advisor activities, with consultation necessary for almost any action that deviates from the ordinary. A change in fee structure, at least for companies with discretionary licenses, requires MoF approval. In considering the change, officials insist upon significant quantities of information about the operations of the advisor.

The degree of supervision includes such routine matters as office locations. Applications for a discretionary license must include a floor plan showing the prospective location of all employees.[123] Similarly, offices must remain physically separate from a parent. When officials of one advisor wanted to relocate to better space on a floor in the same building, MoF refused because the parent already had offices on the same floor.[124] Similarly, when another advisor wanted to have the parent handle certain administrative functions, it had to engage in extensive negotiations with MoF over a three-month period before receiving approval.[125]

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regarding the value of securities, and the investment judgements based on the analysis of the value of securities. *Id.* at art. 34.

121. *Id.* at art. 25.

122. *Id.* at art. 28. The Ministry also had to approve licenses for banks and securities firms. As evidence of the Ministry's tight grip on that authority, it allowed only a handful of exceptions to its general denial of new bank licenses from the end of the occupation through the early 1990s. In the 1950s, it issued licenses for two new long-term banks and several trust banks. *See* BROWN, *supra* note 44, at 394-95. In the mid-1980s, the Ministry allowed the creation of nine foreign trust banks. *See* BROWN, *supra* note 2, at 111-13.

123. Interview with employee of U.S. advisor operating in Japan (July 1993).

124. *Id.*

125. Advisors are prohibited from engaging "in any business other than the business relating to the licensed investment advisory business . . . ." SIAL, *supra* note 94, at art. 31. In addition, "[m]atters other than those prescribed in this law which may be necessary for the enforcement of this law may be prescribed by the Minister of Finance by an ordinance." *Id.* at art. 52.

C. Advertisements

The Securities Investment Advisory Law ("SIAL") contains provisions expressly regulating advertisements.[126] Consistent with the conventional Japanese approach, the provisions are broad in scope, doing little more than prohibiting misleading disclosure. The provisions assign the bureaucracy responsibility for developing more detailed requirements. MoF has dutifully issued an ordinance[127] and a circular[128] containing more specific regulations.

Advertisements have a number of affirmative content requirements. Any description of the business must conspicuously note that the advisor cannot buy or sell securities on behalf of the client and cannot hold deposit money or securities on deposit.[129] In addition, the advertisements must include the registered trade name of the advisor and, if authorized to provide discretionary services, the advisor's license number.[130] Finally, any advisor listing a phone number must specify, to the extent applicable, whether the number is to an answering machine or switchboard.

Certain kinds of information cannot appear in advertisements. They cannot contain untrue statements or statements likely to cause confusion.[131] The advertisement also cannot indi-

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126. The advertisement cannot contain investment information "flagrantly at variance with the facts and grossly misleading." *Id.* at art. 13(2). It also cannot indicate that MoF has recommended the advisor or guaranteed its advice. *Id.* at art. 13(3).

127. Ordinance No. 54, Oct. 1986, as amended. Akin to rules, ordinances are published by the Ministry and distributed to the public. They are not, however, adopted pursuant to notice and comment.

128. MoF Circular No. 993 of 1992. Circulars generally constitute guidelines to officials within the bureaucracy. *See* Oda, *supra* note 39, at 57 (describing circulars as documents "addressed to lower echelons of the administration and local governments in order to give guidelines for the interpretation of the law and the exercise of discretion on their part"). As a practical matter, however, circulars are often distributed to the relevant industry.

129. SIAL, *supra* note 94, at art. 13(1). The disclosure must conform with the requirements set forth by MoF in an ordinance. MoF has dutifully done so. *See* Ordinance No. 54, *supra* note 127, at art. 15(1). Those with a discretionary license need only include the ban on loans. *Id.* at art. 51(2).

130. Circular No. 993, *supra* note 128.

131. SIAL, *supra* note 94, at art. 13(2). Specifically, the advertisements cannot include misleading or confusing statements concerning performance results, investment data, and investment judgments based upon an analysis of the value of securities. *Id.* In addition, MoF may prohibit other types of misleading statements. These include misstatements about (a) the fees charged clients and the method and schedule of the payments; (b) the substance of the advice given and the method of delivering advice; (c) the provisions of the investment advisory agreement, including the cancellation clause; (d) the determination or limitation on an advisor's damages or penalties to a client; (e) the financial position or creditworthiness of an advisor; (f) matters relating to the termination of an agreement; and (g) the scope of the advisor's discretionary investment authority. The advertisement also cannot contain any

cate in any way that MoF, the director general of the relevant bureau, or any other government regulator recommends the advisor or guarantees the advisor's advice.[132] Advertisements cannot list only securities that performed well,[133] a provision similar to one in place in the United States,[134] unsubstantiated claims about performance or that their advice significantly outperformed others,[135] misleading statements about charges for services, particularly false statements about free or inexpensive advice,[136] and overly optimistic statements about expected investment returns designed to attract customers unfairly.[137]

Also banned from advertisements are statements falsely suggesting an advisor without a proper license has the authority to provide discretionary advisory services and misleading statements about the length of time a customer has to access the services.[138] Finally, advertisements may not contain any expression deemed "overly extravagant" or exaggerating the truth.[139]

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statement suggesting a guaranteed minimum yield or that the advisor shall bear any portion of a customer's losses. Ordinance No. 54, art. 16, *supra* note 127.

132. SIAL, *supra* note 94, at art. 13(3).

133. MoF Circular No. 993 of 1992, *supra* note 128, at art. 2, § 2, ¶2, item 1.

134. *See* 17 C.F.R. § 206(4)-1(a)(2) (1992); *see also infra* part III.B.2.

135. MoF Circular No. 993 of 1992, *supra* note 128, at art. 2, § 2, ¶2, item 2. The disclosure of performance data represents a particularly daunting problem for foreign advisors. Japanese advisors compute performance based on book value. They take into account realized gain less realized losses plus cash distributions. They do not factor in unrealized gain or losses. In contrast, U.S. advisors use *total return* which does take into account unrealized gains and losses within the relevant portfolio. The difference in computation has a number of significant implications. First, performance figures are not comparable. Second, those using cash basis can manipulate the results to achieve a consistent, positive gain. Foreign firms would show a far more volatile experience, including, in some years, actual losses. The method has considerable potential for manipulation. To maintain a healthy "performance" record, advisors can sell shares that have risen in value while holding all investments that fell. Thus, even as the advisor shows a positive return, the overall portfolio may be deteriorating significantly. While perhaps an overgeneralization, Japanese companies prefer a stable increase to a higher volatility risk even if the odds are that the latter method will provide the greater return. One U.S. advisor in Japan indicated to the author that they had tried to recompute past performance using the Japanese cash basis method but with uneven effect.

136. *Id.* at item 8. This is another provision apparently lifted from the U.S. *See infra* text accompanying notes 187-89. In addition, the advisor cannot make any misleading or false statements that the term for accepting the services of the advisor or the number of customers accepted by the advisor is limited. *Id.* at item 6.

137. *Id.* at item 10. The advertisement also cannot contain any expression which violates the Law for Preventing Unjustifiable Gratuities and Misleading Representations (Law No. 134 of 1932), the Outdoor Advertisement Act (Law No. 189 of 1919) or any other law, regulation or ordinance of Japan. *Id.* at item 9.

138. *Id.* at item 3.

139. *Id.* at item 4. With these limitations, advertisements—particularly brochures—are predictably bland. They often contain a description of the company and a description of investment policies. In addition, advertisements may include information about clients (by category, without mentioning specific companies) and

The rules of the SIAL add another layer of regulation, providing a number of specific prohibitions. Advertisements cannot violate "commercial morality," statements that would disparage the advisory industry or particular companies.[140] Ads also cannot contain unsubstantiated claims such as "we're number 1."[141] The rules impose other content requirements.[142] To ensure conformity, advertisements must be filed a month before use, with the Association having the right to require changes.[143]

As in other areas of advisory activity, MoF retains considerable discretion over advertising practices. For one thing, the Ministry has never defined the term *advertisement.* With few advisors advertising in the mass media, most rely on the distribution of brochures directly to prospective clients. MoF has not indicated in writing whether these materials—even if individualized—constitute advertisements.[144] This creates uncertainty, thus necessitating bureaucratic guidance.

Furthermore, the statute and the regulations are replete with vague standards such as "overly extravagant" and "cause confusion," with the phrases nowhere defined. Given the regulatory uncertainties, advertisements deviating from current, uniform, industry-wide practices require Ministry acquiescence.[145] This enables MoF to micro-manage advertising practices much as it has done for other aspects of advisor activity.

The use of unwritten guidance can also be seen from the implicit ban on comparative advertisements. The SIAL says nothing about these types of ads. The Circular discussing advertisements merely bans comparisons suggesting that the advisor significantly outperforms others. As a practical matter, however, comparative advertisements do not exist. This suggests an implicit ban by MoF of all comparative advertisements.[146]

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the amount of assets under management. Finally, they sometimes contain data on the performance of the stock market, although they use a general benchmark such as the Nikkei average rather than the advisor's specific performance.

140. *Self-Regulations*, *supra* note 98, at art. 4.

141. *Id.* at art. 13.

142. *See Self-Regulations*, *supra* note 98. The regulations prohibit the use of guarantees, forecasts, and selective disclosure of stock recommendations. *Id.* arts. 11, 12, 14. Advertisements cannot assert an advisor's superiority without "specific data" supporting the claims, cannot publicize "limited opportunities" unless they are actually limited, and cannot charge fees that vary from what was contained in the registration application. *Id.* at arts. 13, 15, 16.

143. *Id.* at arts. 25, 26.

144. In the United States, the Commission has defined the term with exclusions for materials sent to a single prospective client. *See infra* text accompanying notes 161-62.

145. *See* discussion *supra* part I.B.1.

146. Comparable limitations had existed throughout the financial system. In particular, banks were subject to restrictions on comparative advertising. The ban was

III. THE ADMINISTRATIVE STATE IN THE UNITED STATES AND THE REGULATION OF ADVERTISEMENTS BY INVESTMENT ADVISORS

At first blush, the United States appears to have a markedly different system for regulating investment advisors. The Securities and Exchange Commission ("Commission") has the responsibility for overseeing the investment advisory community. Rather than rely on informal governance, the Commission has in place an extensive set of rules governing most facets of advisor behavior.[147] Advisors must register with the Commission[148] on a Form ADV.[149] Unlike Japan, the U.S. system neither requires administrative approval to operate, nor distinguishes between discretionary and non-discretionary licenses.

Among other things, the Investment Advisors Act requires an advisor to maintain certain records,[150] issue disclosure documents to prospective clients[151] and adopt procedures designed to minimize insider trading.[152] Finally, Section 206 provides strong anti-fraud protection from false disclosure, banning any "act, practice or course of business which is fraudulent, deceptive, or manipulative."[153]

Section 206 does more than prohibit fraud. It also gives the Commission broad authority to adopt rules "reasonably designed to prevent" fraud.[154] The language permits the adoption of prophylactic rules which not only bar fraudulent practices but that also are "designed to prevent" such behavior. The Commission used the authority in 1961 to adopt Rule 206(4)-1, a comprehensive provision regulating advertisements.[155]

The rule sought to balance the competing interests of advisors and investors. The Commission recognized that advertisements often went to unsophisticated investors who needed

indirectly imposed by the Federation of Bankers Associations of Japan, although with the support of the Administrative Finance Bureau. The Federation only abandoned the rule in the spring of 1993.

147. The Investment Advisors Act represents the principal source of regulation for those dispensing investment advice. 15 U.S.C. § 80b-1 to -18 (1988).

148. *See* 17 C.F.R. § 275.203 (1992); 15 U.S.C. § 80b-3 (1988).

149. *See* 17 C.F.R. § 275.203-1 (1992); *see also* Applicability of the Investment Advisors Act, Investment Advisors Act Release No. 1092, 1987 SEC LEXIS 3487 (Oct. 8, 1987).

150. 15 U.S.C. § 80b-4 (1988); 17 C.F.R. § 275.204-2 (1992).

151. This is known as the "brochure" rule. 17 C.F.R. § 275.204-3 (1992).

152. 17 C.F.R. § 275.204(A); 15 U.S.C. § 80b-4a (1988).

153. 17 C.F.R. § 275.206(4); 15 U.S.C. § 80b-6(4) (1988).

154. *Id.*

155. 17 C.F.R. § 275.206(4)-1 (1992). The Commission also regulates advertisements by investment companies. *See* 17 C.F.R. § 230.482 (1992).

additional protection.[156] At the same time, however, any rule had to avoid interfering with legitimate advertising techniques. In resolving the conflicts, the Commission struck a balance of sorts. First, by employing a broad definition of advertisement, the rule applied to a wide range of communications.[157] Second, the rule banned certain practices outright. Testimonials, for example, were deemed inherently misleading and therefore absolutely prohibited.[158] Other practices were permitted, but only if surrounded by prophylactic disclosure, including legends.[159]

Almost as an afterthought, the rule also prohibited false and misleading advertisements, a common sort of catch-all.[160] Over time, however, this vague prohibition has subsumed the entire rule. Most Commission pronouncements and enforcement proceedings involve interpretations of the meaning of "false and misleading." The staff has aggressively used the provision to issue broad, sometimes substantive, interpretations concerning advertising practices.

A. Definition of Advertisement

Unlike the Japanese system, rule 206(4)-1 defines advertisements. The term includes any:

> notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.[161] The definition does not apply to face-to-face conversations with a prospective client or a letter sent to a single person.[162]

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156. *See* Notice of Proposed Rule to Prohibit Certain Advertisements, Investment Advisors Act Release No. 113, 1961 SEC LEXIS 782 (Apr. 4, 1961).

157. 17 C.F.R. § 275.206(4)-1. The rule was adopted in 1961. *See* Adoption of Rule 206(4)-1, Investment Advisors Act Release No. 121, 1961 SEC LEXIS 787 (Nov. 2, 1961).

158. *See infra* text accompanying notes 172-79.

159. *See infra* text accompanying notes 180-93.

160. 17 C.F.R. § 275.206(4)-1(a)(5) (1992).

161. 17 C.F.R. § 275.206(4)-1(d) (1992). The rule does not, however, apply to advisory services that are sold. *See* LNB Corp., 1990 SEC No-Act. LEXIS 663 (Apr. 9, 1990).

162. Notice of Revised Proposal to Prohibit Certain Advertisements, Investment Advisors Act Release No. 119, 1961 SEC LEXIS 785 (Aug. 8, 1961); *see also* Denver Investment Advisors, 1993 SEC No-Act. LEXIS 917 (July 30, 1993).

In devising the definition, the Commission seemed primarily concerned with the content of the document, focusing on the nature of the services described in the materials. The definition only encompassed materials containing securities analysis or services. Since then, however, the courts[163] and the Commission[164] have focused more on the purpose of the communication. The definition has been extended to include any materials designed to attract clients, irrespective of their precise content.

In *SEC v. Wall Street Publishing Institute, Inc.*,[165] for example, the court considered whether magazine columns discussing stock picks constituted advertisements. The decision concentrated less on the content of the column and more on the "promotional" nature of the materials. It was not enough that the materials analyzed securities; they also had to attract new customers. Other courts have used similar reasoning.[166]

The staff has likewise emphasized the purpose of the communication. A good example arose in *Financial Institutions Investment Services, Inc.*[167] An advisor proposed advertisements that included testimonials but referred only to "portfolio administration" and the advisor's ability to provide "maximum portfolio attention." The materials made no mention of any type of securities analysis or investment services.

Nevertheless, the SEC staff indicated that the document "clearly" came within the definition of advertisement. While little reasoning accompanied the conclusion, the staff seemed primarily concerned with widespread distribution to obtain clients. Characterized as an advertisement, the document could not include the testimonial.[168]

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163. The term "advertisement" has been held to include any "investment advisory material which promotes advisory services *for the purpose of inducing potential clients to subscribe* to those services . . . ." SEC v. C.R. Richmond & Co., 565 F.2d 1101, 1105 (9th Cir. 1977) (emphasis added).

164. *See* Paul K. Peers, Inc., 42 S.E.C. 539, 540-41 (1965); *see also* Joseph W. Quarles, 1980 SEC No-Act. LEXIS 2864 at *2 (Feb. 14, 1980) (materials used for "inducing potential clients to subscribe" to advisor's services constituted an advertisement); John W. Uher, 1977 SEC No-Act. LEXIS 2011 at *2 (Aug. 5, 1977) ("If copies of your market report are distributed to solicit new subscribers, the publication itself would probably be regarded as an 'advertisement'. . ."); Charles L. Hatfield, 1975 SEC No-Act. LEXIS 190 at *2 (Jan. 29, 1975) (materials disseminated "to potential as well as existing clients" constituted advertisements).

165. 591 F. Supp. 1070 (D.D.C. 1984), *rev'd on other grounds*, 851 F.2d 365 (D.C. Cir. 1988).

166. *See, e.g.*, SEC v. C.R. Richmond & Co., *supra* note 163; *see also* In re National Counselor Reports, Investment Advisors Act Release No. 757, 1981 SEC LEXIS 1681 (Apr. 8, 1981).

167. Fin. Inst. Inv. Serv., Inc., 1985 SEC No-Act. LEXIS 2282 (June 12, 1985).

168. *Id.* Similarly, the staff has found that materials containing a description of an advisor's investment services constitute an advertisement even if distributed only to industry consultants and even though provided only on request. The staff rea-

What seems clear is that any public communication designed to induce someone to use a particular advisor, even for administrative functions, will be treated as an advertisement. The communication, therefore, need not be labeled as such. It need only contain enough information about the advisor's practices to generate client interest in a relationship.[169] Even articles produced by an unrelated third party but distributed by the advisor may constitute advertisements.[170]

B. Specific Practices

Anything deemed an advertisement must conform to the requirements of Rule 206(4)-1. The rule addresses a number of specific practices. In particular, the provision regulates the use of testimonials, stock recommendations, graphs and charts, and services described as free.[171] The staff's interpretation of the rule has illustrated a penchant for informal, sometimes unwritten, interpretations.

1. *Testimonials*

An advertisement may not include testimonials.[172] Specifically, the rule prohibits the distribution of any advertisement "[w]hich refers, directly or indirectly, to any testimonial of any kind concerning the investment advisor or concerning any advice, analysis, report or other service rendered by such investment advisor."[173] The ban applies even when the testimonials "are unsolicited and are printed in full."[174]

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soned that the "ultimate purpose" of the materials was to maintain existing, and obtain new, clients. *See also supra* note 162.

169. Even the distribution of a list of all recommendations to existing and prospective clients has been held to be an advertisement. *See* Foster & Marshall, 1977 SEC No-Act. LEXIS 396 (Feb. 18, 1977).

170. *See infra* notes 263 and 190.

171. *See infra* notes 172-90 and accompanying text.

172. *See* Cigna Securities, 1991 SEC No-Act. LEXIS 1184 (Sept. 10, 1991); Richard Silverman, 1985 SEC No-Act. LEXIS 2003 (Mar. 27, 1985); J.Y. Barry Arbitrage Mgmt., 1989 SEC No-Act. LEXIS 1074 (Oct. 18, 1989). *See also* In re Schrott, Whitaker and Douglas, Investment Advisors Act Release No. 260, 1970 SEC LEXIS 932 (Mar. 20, 1970) (sanctioning advisor for improperly including testimonials and advertisements).

173. 17 C.F.R. 275.206(4)-1(a)(1) (1992). The rule only banned testimonials concerning the advisor. This would seem to permit testimonials that relate to the need for general money manager services. Even here, however, the staff would likely be unhappy with a general testimonial in a specific advertisement by an advisor. The context would give the impression that the testimonial applied to the advisor. The staff might characterize the practice as an "indirect" testimonial or, more likely, as misleading under subsection (a)(5).

174. Adoption of Rule 206(4)-1, *supra* note 157.

The ban arose out of the Commission's belief that testimonials were inherently misleading.[175] Testimonials could "give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the advisor's clients."[176] The complete ban, however, had significant implications. Once a practice was characterized as a testimonial, it was prohibited. A broad interpretation of "testimonial" threatened to impede acceptable advertising techniques.

Subsequent staff interpretation has been sensitive to this concern. The small number of no-action letters addressing testimonials have only applied the term to statements "of a customer's experience or endorsement,"[177] particularly customers' express representations about the advisor's services.[178] The staff, therefore, has not generally expanded the term beyond its plain and limited meaning.[179]

2. *Recommendations*

Rule 206(4)-1 also banned advertisements that contained "specific recommendations . . . which . . . would have been profit-

175. *See id.* at 2 ("The Commission finds that such advertisements are misleading; by their very nature they emphasize the comments and activities favorable to the investment advisor and ignore those which are unfavorable. This is true even when the testimonials are unsolicited and are printed in full.").

176. New York Investors Group, 1982 SEC No-Act. LEXIS 2794 (Sept. 7, 1982); *see also* CIGNA Securities, *supra* note 172; J.Y. Barry Arbitrage Mgmt., *supra* note 172.

177. CIGNA Securities, *supra* note 172; J.Y. Barry Arbitrage Mgmt., *supra* note 172.

178. *See, e.g.*, CIGNA Securities, *supra* note 172 (concluding that written statements from satisfied financial planning clients constitute a testimonial); Investor Intelligence (John Anthony), 1975 SEC No-Act. LEXIS 764 (Apr. 18, 1975) (advertisement describing advisor as a "recognized" powerful psychic medium constituted a testimonial).

179. Two notable exceptions to this restrained approach have, however, arisen. These include the use of client lists and celebrity endorsements. *See infra* notes 206-11, 268-72 and accompanying text.

The staff's construction is most clearly illustrated in connection with letters addressing the distribution by advisors of articles and reports written by third parties. Similar to a testimonial, articles often contain conclusions about an advisor's ability and performance. The staff, however, has declined to construe them as testimonials unless containing a statement of "a customer's experience or endorsement." Richard Silverman, *supra* note 172; N.Y. Investors Group, *supra* note 176; Money Magazine, 1989 SEC No-Act. LEXIS 274 (Feb. 22, 1989). The staff apparently did so out of belief that *unbiased* third party statements were not inherently misleading and therefore did not raise the types of concerns that lead to the ban on testimonials. *See* Kurtz Capital Mgmt., 1988 SEC No-Act. LEXIS 108 (Jan. 18, 1988). Of course, the advisor will generally distribute only favorable articles, raising the very problem posed by testimonials.

able to any person . . . ."[180] The provision essentially prohibited selective disclosure of profitable recommendations.[181] As the Commission noted in adopting the provision, "material of this nature, which may refer only to recommendations which were or would have been profitable and ignore those which were or would have been unprofitable, is inherently misleading and deceptive . . . ."[182]

The focus was on selective disclosure. An advertisement could include a complete list of all recommendations made over the prior year,[183] or it could offer to furnish a list of *all* recommendations made by the advisor within a specified period.[184] The advisor could not, however, selectively disclose recommendations while also promising to provide a complete list upon request.[185] The list also must contain prophylactic disclosure designed to minimize the potential for abuse. This disclosure

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180. 17 C.F.R. § 275.206(4)-1(a)(2) (1992). *See also* SEC v. C.R. Richmond & Co., *supra* note 163 (finding disclosure of specific past recommendations a violation of Rule 206(4)-1(a)(2)). The prohibition applies only to "profitable" recommendations. This suggests that specific recommendations showing a loss could be advertised. While this may sound unlikely, an advisor may want to advertise these types of recommendations in a falling market to show that it outperformed the market by having a smaller loss. Again, however, the staff could take the position either that "profitable" had a broader meaning and applied to any "successive" recommendation or, more likely, was false and misleading because of its selective nature.

181. Indeed, as originally proposed, the rule would have prohibited the use of advertisements which called attention to profitable past recommendations of any sort. *See* Notice of Proposed Rule, *supra* note 156.

182. Adoption of Rule 206(4)-1, Investment Advisors Act Release No. 121, 1961 SEC LEXIS 787 (Nov. 2, 1961).

183. The publication of an entire list of recommendations, however, may still be misleading to the extent it implies that prospective clients will achieve a comparable performance. Dow Theory Forecast, 1983 SEC No-Act. LEXIS 2756 (Aug. 26, 1983); *see also* James D. Oberweis, 1983 SEC No-Act. LEXIS 2650 (July 25, 1983).

184. The period could not be less than one year. 17 C.F.R. § 275.206(4)-1(a)(2) (1992). Commission enforcement proceedings in this area have contained some inconsistent, indeed incorrect, language concerning this requirement. In at least two cases, the Commission indicated that it was a violation of Rule 206(4)-1(a)(2) to include specific recommendations without setting out all other recommendations *or* offering to furnish a list of all such recommendations. *See, e.g.*, In re Bond Timing Serv., Investment Advisers Act Release No. 920, 1984 SEC LEXIS 1102 (July 23, 1984); In re Jay Erroll Weinberg, Investment Advisers Act Release No. 918, 1984 SEC LEXIS 1139 (July 13, 1984). This was not an either-or issue. Once specific recommendations are included, Rule 206(4)-1 requires that all other recommendations made within the prior year be included.

185. James B. Peeke & Co., 1982 SEC No-Act. LEXIS 3131 (Sept. 13, 1982). In requiring distribution of complete lists, the staff has shown little flexibility. Officials have, for example, objected to the use of a list that contains a complete list of recommendations for a particular investment objective. Foster & Marshall, 1977 SEC No-Act. LEXIS 396 (Feb. 18, 1977). *See also* Proposal to Adopt Rule 206(4)-3, Investment Advisers Act Release No. 231, 1968 SEC LEXIS 1325 (Oct. 10, 1968) (noting that modification of rule was intended to "make it clear that an advertisement by an investment adviser which refers to past specific recommendations must contain all recommendations made within a period of time not less than one year, or offer to

must include a cautionary legend printed as large as the largest type-style used in the body of the advertisement[186] and state the name of each security recommended, the date and nature of the recommendation, and information about the price of the security.[187]

The staff has issued a number of informal interpretations in the area, particularly in connection with the distribution of a "bona-fide news article written by an unbiased third party . . . ."[188] The ban on recommendations generally does not apply to those articles. The staff has, however, noted that the rule extends to third-party articles containing specific recommendations.[189] Distribution of third-party materials is subject to the general prohibition on false or misleading advertisements.[190]

With respect to recommendations, the rules also require the retention of supporting documentation. The advisor must keep sufficient materials "to document the nature of the recommendations, when they were made, and any assumptions made to compute performance, e.g., that the customer acted on the recommendations at a given time."[191] Records required under the rule do not have to be retained on hard copy, but can be stored on magnetic disk, tape, or other computer storage medium.[192] The advisor must retain the materials for five years.[193]

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furnish a list of all of them; that the advertisement cannot list some, and offer to furnish the rest in a list.").

186. The legend must state that: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list." 17 C.F.R. § 275.206(4)-1(a)(2) (1992). Failure to include the legend has resulted in administrative sanctions. *See* In re National Counselor's Report, Investment Advisers Act Release No. 757, 1981 SEC LEXIS 1681 (Apr. 8, 1981).

187. Price information includes the market price at that time, the price at which the recommendation was to be acted upon, and the current market price. 17 C.F.R. 275.206(4)-1(a)(2) (1992); *see also* The Budlong Market Letter, 1982 SEC No-Act. LEXIS 3032 (July 29, 1982).

188. Kurtz Capital Mgmt., *supra* note 179.

189. Dow Theory Forecast, *supra* note 183; N.Y. Investors Group, *supra* note 176.

190. A third-party article would be misleading if it implied "something about, or is likely to cause an inference to be drawn concerning, the experience of advisory clients, the possibility of a prospective client having an investment experience similar to that of prior clients, or the advisor's confidence when there are additional facts that, if disclosed would imply different results from those suggested in the article." Kurtz Capital Mgmt., *supra* note 179; N.Y. Investors Group, *supra* note 176.

191. Recordkeeping by Investment Advisers, Investment Advisers Act Release No. 1135, 1988 SEC LEXIS 1680 (Aug. 17, 1988).

192. 17 C.F.R. § 275.204-2(g)(2) (1992). *See also* Recordkeeping by Investment Advisers, Investment Advisers Act Release No. IA-1093, 1987 SEC LEXIS 3263 (Nov. 5, 1987).

193. 17 C.F.R. § 275.204-2(e)(3) (1992). For the first two years, the materials had to be in "an appropriate office" of the advisor. In addition, the time period ran from the date of the last publication or distribution of the advertisement. Thus, an advi-

3. *Charts/Graphs/Formulas*

In addition to testimonials and specific recommendations, the rule also regulates the use of advertisements containing any "graph, chart, formula or other device" that assist investors in determining particular securities to buy or sell.[194] The approach to charts and graphs differs from testimonials and specific recommendations. Rather than containing an outright prohibition, the rule requires disclosures designed to accurately characterize the material. Use of a chart or graph may only occur if accompanied by "prominent disclos[ure] . . . [of] the limitations thereof and the difficulties with respect to its use."[195] The staff has sanctioned advisors for failing to disclose these limitations.[196]

4. *Free Services*

Lastly, the rule also prohibits any promise to provide a report, analysis or other service "free" or "without charge," unless in fact no fee would actually be charged.[197] Thus, a newsletter publisher cannot offer a "free" subscription to anyone who acquired a subscription where the Dow Jones industrial average did not rise ten points during the subscription period.[198]

The provision applies only to reports, analysis, or other services. No staff letter has discussed whether the provision would apply to merchandise offered to induce a client to accept the investment advisor's services. The staff has, however, viewed the phrase "other services" broadly and included activities not directly related to investment advisory activities.[199]

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sor using performance data for a ten-year period would have to save supporting data for the entire ten years for the five-year period after the last publication. Recordkeeping by Investment Advisers, *supra* note 192.

194. As originally proposed, the rule would have applied not only to graphs, charts, or formulas, but also to methods or systems. Notice of Proposed Rule, *supra* note 156. Commentators indicated that the use of these terms meant that the requirement applied to every offer of any investment advisory service. To avoid that broad connotation, the Commission deleted the words from the final proposal. Notice of Revised Proposal, *supra* note 162.

195. 17 C.F.R. § 275.206(4)-1 (1992). As originally proposed, the disclosure of the limitations and difficulties had to be disclosed "in close juxtaposition and with equal prominence." Notice of Proposed Rule, *supra* note 156. The juxtaposition requirement was eliminated to make clear that "if such limitations and difficulties are disclosed prominently anywhere in the advertisement, it need not be repeated on each page of the advertisement or on each graph or chart." Notice of Revised Proposal, *supra* note 162.

196. In re Eric S. Emory, Investment Company Act Release No. 18245, 1991 SEC LEXIS 1458 (July 22, 1991); In re Richard W. Suter, Investment Advisers Act Release No. 886, 1983 SEC LEXIS 540 (Oct. 17, 1983).

197. 17 C.F.R. § 275.206(4)-1(a)(4) (1992).

198. Dow Theory Forecast, 1986 SEC No-Act. LEXIS 2303 (May 21, 1986).

199. *See, e.g.*, Tax and Estate Planners, 1985 SEC No-Act. LEXIS 2071 (Apr. 22, 1985) (noting an offer to provide a will to anyone agreeing to an initial consultation

C. FALSE AND MISLEADING

In addition to the specific pronouncements, Rule 206(4)-1(a)(5) bars any untrue or otherwise misleading statement of material fact in an advertisement.[200] An exceedingly amorphous requirement, this provision has caused the most difficulty in application and has been the provision most often used to justify novel interpretations of the rule. The uncertainty of the phrase has accorded extraordinarily broad discretion to the staff.

In determining what is "false and misleading," the staff has noted that resolution depends on the particular facts and circumstances, "including (1) the form as well as the content of the advertisement, (2) the implications or inference arising out of the advertisement and its total context, and (3) the sophistication of the prospective client."[201] More specifically, the staff has emphasized that an advertisement will be misleading:

> if it implies something about, or is likely to cause an inference to be drawn concerning, the experience of advisory clients, the possibilities of a prospective client's having an investment experience similar to that which the performance data suggest was enjoyed by the advisor's clients, or the advisor's competence, when there are additional facts which the advisor knew or ought to have known, which if also disclosed would prevent the implication from arising or the inference from being drawn.[202]

False statements about an advisor's expertise represent the easy case. Advisors have been sanctioned for incorrectly stating academic credentials,[203] professional titles,[204] and years of expe-

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for estate, tax, or financial advisory services, was subject to the requirements of the Rule).

200. 17 C.F.R. § 275.206(4)-1(a)(5) (1992).

201. Muller Assoc., 1992 SEC No-Act. LEXIS 801 (June 17, 1992); Clover Capital Mgmt., 1991 SEC No-Act. LEXIS 978 (July 19, 1991); Covato/Lipsitz, 1981 SEC No-Act. LEXIS 4154 (Oct. 23, 1981); Morill Stanfill & Co., 1978 SEC No-Act. LEXIS 1046 (Apr. 13, 1978); Anametrics Investment Mgmt., 1977 SEC No-Act. LEXIS 1656 (May 5, 1977). *See also* SEC v. C.R. Richmond & Co., *supra* note 163, at 1104 ("The term 'advertisement' is broadly defined in Rule 206(4)-1(b), and conduct with respect to these rules must be measured from the viewpoint of a person unskilled and unsophisticated in investment matters." (footnote omitted)).

202. Dow Theory Forecast, *supra* note 198. The staff has often repeated this standard. *See* Fiduciary Mgmt. Assoc., 1984 SEC No-Act. LEXIS 1962 (Mar. 5, 1984); Anametrics Investment Mgmt., *supra* note 201.

203. In re Dave Mason, Investment Advisors Act Release No. 1200, 1989 SEC LEXIS 1805 (Sept. 18, 1989) (seven college degrees).

204. In re David S. Quintana, Investment Advisors Act Release No. 1253, 1990 SEC LEXIS 3161 (Sept. 27, 1990) (use of terms "Certified Financial Analyst" and "certified tax practitioner," neither of which were recognized under state law or by the Institute of Chartered Financial Analysts).

rience.[205] Listing fictitious people with fictitious titles and indicating that the media had "discovered" the advisor when the only mention came in paid advertisements were both considered misleading.[206] Similarly, suggestions that the advisor's services or techniques were approved by a government regulator violated the rule.[207]

The Commission has also sanctioned advisors for false statements about the advisor's clients. Thus, a statement that the services had been used by "a selected clientele of institutional investors from widely separate points of the country" rendered the advertisement false and misleading.[208] Similarly, statements that the advisor had guided "hundreds of doctors"[209] and had given advice to a specified number of investment advisory clients

205. *See* In re GJH Corp., Investment Advisors Act Release No. 208, 1967 SEC LEXIS 927 (Mar. 3, 1967) (advisor falsely stated that he had retired at age 38 because of success in investing). An interesting example of this arose in In re Richard W. Suter, Investment Advisers Act Release No. 886, 1983 SEC LEXIS 840 (Oct. 17, 1983). In that case, the adviser represented that he had experience analyzing the stock market that spanned 20 years. He did not disclose in the advertisement, however, that he was only 34 at the time. "Thus, he had assertedly begun to watch the market and develop his analytical techniques from the time he was 13 or 14 years of age." *Id. See also* In re Martone, Investment Advisors Act Release No. IA-1089, 1987 SEC LEXIS 3566 (Sept. 30, 1987) (falsely indicating that adviser had 25 years of securities experience); In re Cabot Money Mgmt., Investment Advisers Act Release No. IA-1063, 1987 SEC LEXIS 2292 (Mar. 23, 1987) (statement that employee worked for adviser for "years" misleading where it consisted of two summers).

206. *See* SEC v. Financial News Associates, [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,026 (E.D. Va. Apr. 26, 1985), *vacated*, June 21, 1985. *See also* In re Market Lines, Investment Advisors Act Release No. 206, 1967 SEC LEXIS 929 (Jan. 20, 1967) (noting that use of phrase "financial scientist" was misleading "in implying that techniques for evaluating securities can be reduced to an exact science").

207. *See, e.g.*, In re Money Machine, Investment Advisors Act Release No. 783, 1981 SEC LEXIS 359 (Nov. 12, 1981) (advisor indicated that computerized "system" or formula of stock management had been registered by the Commission); *see also* SEC v. Blavin, 557 F. Supp. 1304 (E.D. Mich. 1983) ("An additional misstatement is that the letter says that the Provident Investment Advisory is 'a chartered and registered service,' which it was not."); SEC v. Quintana, Litigation Release No. 12623, 1990 SEC LEXIS 3126 at *2 (C.D. Cal. Sept. 19, 1990) (adviser's description as a "certified tax practitioner with the State of California" and as a financial analyst "chartered . . . with the State of California Department of Corporation" where the state had approved none of the designations). In a somewhat odd pattern, an adviser issued a newsletter explaining that the CEO of a company had been pressured by the Commission to tone down his speech at the company's annual meeting. The Commission found the statement to be misleading, noting that no official had attended the annual meeting or otherwise pressured the CEO. In re Prof. Advisory Serv., Investment Advisers Act Release No. 774, 1981 SEC LEXIS 737 (Sept. 16, 1981).

208. Investment Advisors Act Release No. 115, 1961 SEC LEXIS 784 at *2 (July 5, 1961).

209. In re Prof. Advisory Serv., *supra* note 207.

were treated as misleading.[210] Finally, an advertisement indicating that services were used by banks and charitable organizations was misleading where the advisor had only one bank and no charitable clients.[211]

Disclosure of performance results has been an area of particular concern. Violations included nondisclosure of the risks of a particular investment strategy,[212] misstatements of the advisor's mix of business, and the use of results from a non-representative sampling of accounts.[213] Publicizing data from selected accounts with higher returns or from particular time periods with unusually attractive results will be treated as misleading.[214]

From time to time, the staff has specified the types of omissions or incomplete statements that will render performance data misleading.[215] In *In re Grossman*,[216] the advisor published performance data for a three-year period but included only the results of those accounts which had been opened in the first year and remained open throughout the period. The Commission found this to be misleading.[217]

Similarly, in *Clover Capital Management, Inc.*, the staff indicated that advertisements would be misleading if they: (1) failed to disclose the effect of material market or economic conditions

210. In re J.H. Ayres & Co. Investment Company Act Release No. 1363, 1993 SEC LEXIS 264 (Feb. 5, 1993).

211. In re Cabot Money Mgmt., *supra* note 205.

212. In re Makrod Investment Assoc., Investment Advisors Act Release No. 1176, 1989 SEC LEXIS 1220 (July 3, 1989); In re George S. Goldner, Investment Advisers Act Release No. 1118, 1988 SEC LEXIS 1042 (May 16, 1988) (nondisclosure of risks associated with use of uncovered options); *see also* In re Investors Portfolio Mgmt., Investment Advisers Act Release No. 1236, 1990 SEC LEXIS 1254 (June 26, 1990) (fraudulently representing that dividends paid by fund were exempt from California income tax); In re The Blue Chip Market Advisor, Investment Advisers Act Release No. 1207, 1989 SEC LEXIS 2040 (Oct. 25, 1989) (failing to disclose in advertisements that recommendations consisted entirely of options).

213. In re Harvest Financial Group, Investment Advisors Act Release No. 1155, 1989 SEC LEXIS 319 (Feb. 21, 1989).

214. *See* BanCal Capital Mgmt. Corp., SEC No-Act. LEXIS 942 (Dec. 4, 1974). *See also* In re Managed Advisory Serv., Investment Advisers Act Release No. 1148, 1988 SEC LEXIS 2556 (Dec. 27, 1988) (advisor offering switching service that failed to disclose that application of timing signals to hypothetical investments in other fund combinations produced substantially different and, except for one fund, lower performance results); In re Max Edward Zavanelli, Investment Advisers Act Release No. IA-1077, 1987 SEC LEXIS 3962 (1987) (failure to disclose that three of six years' performance data derived from model portfolios in years in which no actual trading occurred).

215. *See* In re Grossman, Investment Advisors Act Release No. 1142, 1988 SEC LEXIS 1979 (Sept. 30, 1988) (results based on select accounts overstated yearly return by 1.7% through 3.1%); *see also* In re Martone, *supra* note 205.

216. In re Grossman, *supra* note 215.

217. *Id.* The data excluded results of any accounts which had been liquidated or any accounts opened after the first year.

on the results portrayed; (2) failed to disclose whether and to what extent the results reflected the reinvestment of dividends and other earnings; (3) used suggestions or claims about the potential for profit without also disclosing the possibility of losses; or (4) failed to disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed.[218]

Most of these cases involved little subtlety. They typically contained blatantly inaccurate statements about an important aspect of an advisor's business, qualifications, or performance. The staff, however, has used the rule to regulate more marginal behavior. Numerous cases have challenged disclosures that, while accurate, did not tell the "full" story, particularly about performance results.[219] As the Commission put it: "The use of such advertisements was in violation of registrant's obligation to use restraint and balance in his advertising and to include a prominent and adequate warning of the limitations and difficulties involved in the use of the devices offered by his advisory service."[220]

Advisors are, for example, assumed to base performance on results from discretionary accounts.[221] To the extent performance includes nondiscretionary accounts (where recommendations may be refused), the advertisement must disclose the fact.[222] In some circumstances, the staff has indicated the need

218. The staff noted the need to disclose that, during the period in which the advisor had a return of 25%, the market also appreciated by 40%. Clover Capital Mgmt., Inc., SEC No-Act. LEXIS 2883 (Oct. 28, 1986).

219. SEC v. C.R. Richmond & Co., *supra* note 163; *see also* Spear & Staff, Inc., Investment Advisors Act Release No. 188, 1965 SEC LEXIS 791 (Mar. 25, 1965). As the Commission put it:

> While respondents' brochure did not have the flamboyant, highly exaggerated and dramatic character of certain other advertisements we have found in violation of the Act, we conclude that it failed to comply with the standards of the Act in that it improperly overemphasized and overstated the amounts and probabilities of gains and understated the risk and speculative elements involved.

Stanford Investment Mgmt., Inc., Investment Advisers Act Release No. 228, 1968 SEC LEXIS 993 at *8 n.9 (Aug. 30, 1968).

220. In re Chart Service Inst., Investment Advisors Act Release No. 267, 1970 SEC LEXIS 928, at *2 (July 30, 1970).

221. In general, the use of performance results attributable to a different advisor, including affiliates or a prior investment advisor, is not permitted. *See* In re Phoenix Asset Mgmt., 1990 SEC LEXIS 3270 (Sept. 25, 1990). The staff will tolerate some use of affiliate results but only with proper explanatory disclosure. *See* Conway Asset Mgmt. Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 347 (Jan. 27, 1989) (disclosure of performance of personal accounts not managed by advisor permissible under principal of advisor managed accounts and there were no material differences between the results of the accounts).

222. In re Fred Alger Mgmt., Inc., Investment Advisors Act Release No. 1222, 1990 SEC LEXIS 347 (Feb. 26, 1990); *see also* Donaldson, Lufkin & Jenrette, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 2367 at *2 (Mar. 2, 1977) ("In addition, the use of percentage figures to demonstrate the gains or losses, and the average

for information about the general performance of the market in order to put the advisor's return into proper perspective.[223]

An advertisement may need to include the size of the accounts used to determine performance, if material.[224] The use of average, unweighted performance figures may also convey a misleading impression, at least where the results mask material differences in accounts.[225] Finally, the staff has noted the importance of disclosing anomalous or unique factors that could affect performance.[226] This would include situations where the advisor had too few client accounts to obtain a representative sampling.[227]

In re Investors Portfolio Management, Inc. illustrates the type of "accurate" disclosure that nonetheless provided a misleading impression.[228] The advisor to a bond fund adopted a strategy of buying bonds in odd lots with short settlement dates. The objective was to acquire bonds unlikely to be delivered on the settlement date. Undelivered bonds accrued interest from the settlement date even though the purchase price had not been paid. This allowed the advisor to reinvest the funds and in effect obtain double interest payments, resulting in a dramatically higher yield.

The Commission sanctioned the advisor for not disclosing the strategy and for not disclosing that the high yields were unsustainable. The Commission found wholly inadequate the inclusion of statements that current yield "[might] not be indicative of future yields."[229] As the opinion noted:

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gain or loss, which would have resulted from investing in the securities which were recommended may also be misleading because it implies investment results that may not have occurred.").

223. *See* Multinational Investments, Inc., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 2367 at *2 (July 17, 1977) ("Thus, statements that accounts appreciated in value 25% may cause an inference to be drawn about advisory competence that would not be drawn if it was also stated that the S&P 500 increased 40% during the same period.").

224. *See* O'Keefe, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1046 (Mar. 14, 1978). The staff seemed concerned with the use of investment returns from small accounts.

225. *See* Multinational Investments, Inc., *supra* note 223.

226. *See* Universal Heritage Investments Corp., SEC No-Action Letter, 1976 SEC No-Act. LEXIS 1875 (Aug. 19, 1976) (noting the need to disclose for any small portfolio that large portion of gain resulted from single transaction and that largest portion of gains were realized in first few months after program's inception).

227. The staff has on occasion indicated concern with the use of "representative" accounts. *See* Avatar Investors Assoc. Corp., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2612 (Dec. 12, 1975).

228. Investors Portfolio Mgmt., Inc., Investment Advisors Act Release No. 1236, 1990 SEC LEXIS 1254 at *5 n.2 (June 26, 1990).

229. *Id.*

"[T]he notation did not appear in all of the advertisements. Moreover, this limited disclaimer hardly constituted full disclosure. In addition, while [the advisor] disclosed [the] fund's current yield to telephone callers, only those who specifically inquired about the reason for the high yield were informed of [the] fund's high proportion of failed bonds."[230]

D. Going Beyond the Statutory Framework

1. *In General*

While the precise issues addressed in Rule 206(4)-1 may seem unusual, little doubt exists about the Commission's authority to adopt prophylactic rules regulating the content of advertisements. The language permits rules "reasonably designed" to prevent fraud. This includes practices that in and of themselves do not involve, but do prevent, fraud.[231] Other provisions with similar language have been given broad construction by the courts.[232]

Things become a bit dicier, however, over staff interpretation of the rule. The staff has used the prohibition on false and misleading statements to implement a number of substantive requirements not supported by the language of the rule. The requirement that advertisements contain net rather than gross performance data represents an obvious example. The staff has

230. *Id.* Although a disclosure statute, the courts and the Commission have generally not looked favorably upon cautionary admonitions as a means of putting investors on notice of concerns. In SEC v. C.R. Richmond & Co., *supra* note 163, the defendant issued a book and newsletter which described the strategy for determining when to buy and sell shares of mutual funds. The book used words such as "infallibility" to describe the process and noted that "[t]his highly accurate indicator has been wrong only once in nineteen years . . . ." *Id.*, at 1105. Although surrounded by cautionary admonitions, the court found the statements misleading. The warnings would not protect an advertisement from challenge at least where "not sufficiently prominent so that 'the numerous uncertainties and imponderables inherent in any attempt to forecast securities prices' are both minimized and obscured." *Id.*, at 1105-06. *See also* In re Investors Institute, Inc., 1970 SEC LEXIS 1466 at *22 (Mar. 13, 1970) (noting that cautionary language insufficient where language "was preceded and followed by highly optimistic statements that counteracted any possible cautionary effect"). Thus, inserting a caveat in the ninth of ten notes to an advertisement would be insufficient to warn investors of potential pitfalls. *See, e.g.*, Stanford Investment Mgmt., Inc., *supra* note 219; *see also* Spear & Staff, Inc., *supra* note 219 at *12 ("there were occasional caveats, but they were unobtrusively worded and placed, being generally preceded and followed by highly optimistic statements that set-off any cautionary effect."); In re Investors Institute, Inc., *supra* at *17 ("While part of text indicated there was no assurance that a potential customer would duplicate the results depicted, the flamboyant statements were [still] misleading . . .").

231. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

232. *See, e.g.*, SEC v. Peters, 978 F.2d 1162 (10th Cir. 1992) (Section 14(e) of the Securities Exchange Act of 1934); U.S. v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc) (same), *cert. denied*, 112 S. Ct. 1759 (1992).

expressly rejected alternatives, including the disclosure of gross performance figures and the fees charged for the services.[233]

The staff has also used informal means to alter the requirements of the rule, thereby avoiding the notice and comment requirements of the APA.[234] No-action letters and unwritten interpretations have overtaken the language of the rule. The staff may therefore shift positions with few formalities. This occurred in connection with pronouncements on the use of model portfolios.[235]

The informal approach and the extensive use of the vague admonition on false disclosure have been used to implement the staff's philosophical views on the appropriate nature of advisor advertising. At one time, the Commission's views were blatantly paternalistic. In the mid-1960s, the agency articulated its principal mission as the protection of the unwary.[236] This approach resulted in overly broad restrictions on advertising techniques deemed unacceptable for unsophisticated investors. The ban on model portfolios and the use of client lists arose during this period.

In more recent years, however, the paternalistic flavor has been replaced by a policy of standardization. Efforts have been underway to create uniformity in advisor advertisements, an idea borrowed from the mutual fund area.[237] The requirement to disclose net performance data did exactly that. Because of variations in expenses, the requirement ensured uniformity and facilitated comparability of advisor performance.

2. *The Staff's Approach*

In going beyond the language of Rule 206(4)-1, the staff has used two basic approaches. In some instances, information in an advertisement must be accompanied by adequate prophylactic disclosure. In particular, the use of model portfolios and comparative indexes represent examples. Neither have been prohibited, but both require cautionary or explanatory language.

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233. "In our view it is inappropriate to require a reader to calculate the compounding effect of the undeducted expenses on the advertised performance figures." Investment Co. Inst., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2362 at *4-5 (Aug. 24, 1987).

234. No-action letters represent informal staff views. As such, they are neither rules nor final agency positions. *See infra* note 287.

235. *See infra* notes 238-43 and accompanying text.

236. *See* Spear & Staff, Inc., *supra* note 219.

237. *See, e.g.*, Securities Act Release No. 33-6850, 1990 SEC LEXIS 38 at *5 (Jan. 8, 1990) (noting that in mutual fund area, rules were designed to ensure "uniformly-computed performance of information" in advertisements).

The staff has, however, gone beyond disclosure requirements. In some instances, the positions have effectively grafted substantive requirements onto the rule. The use of gross, rather than net, performance fees in advertisements has been flatly prohibited, as has the use of celebrity endorsements. No amount of prophylactic disclosure will suffice.

The imposition of substantive requirements has, however, been the clearest in connection with the use of testimonials. Rule 206(4)-1 prohibits such testimonials. Any advertising practice characterized as a testimonial, therefore, violates the rule. At one time, the staff took the position that the use of client lists constituted a testimonial. More recently, the staff has emphatically prohibited the use of celebrity endorsements, characterizing them as testimonials.

3. *Disclosure Requirements*

a. Models

In general, advisors compute performance based upon actual results. On occasion, however, they may use "model" or hypothetical accounts. This arises most often where advisors devise investment styles and want to illustrate how they would have performed. The staff at one time flatly opposed the use of model portfolios. The Commission, however, ultimately abandoned its opposition in favor of prophylactic disclosure.[238]

The advertisements must state that models do not represent actual trading and that they may not reflect the impact that material economic and market factors could have had on the advisor's decision-making, had actual funds been under management.[239] The cautionary language arose from the Commission's belief that an advisor did not have the same market pressures in connection with a model portfolio and could act differently than with actual client accounts.[240]

In addition, the advertisement must: (1) disclose any material changes in the conditions, objectives, or investment strategies

238. *See* A. R. Schmeidler & Co., 1976 SEC No-Act. LEXIS 1205 (June 1, 1977). *See, e.g.,* SEC v. C.R. Richmond & Co., *supra* note 163; *see also* Killgore Mgmt., Investment Advisors Act Release No. 332 (Aug. 25, 1972). The position did not, however, receive much support from the courts.

239. Clover Capital Mgmt., Inc., *supra* note 218. *See also* A. R. Scheidler & Co., *supra* note 238 ("More specifically, it is easier to stay with a hypothetical portfolio when things are going badly; there is no way of assuring that with a real portfolio using customers' money the advisor would not lose his nerve and change his method.").

240. The Commission has sanctioned advisors for failing to include these prophylactic disclosure requirements. *See* In re Emory, Investment Advisors Act Release No. 1283, 49 SEC Docket No. 7 (Aug. 6, 1991).

of the model portfolio over the period portrayed and the effects of any change; (2) disclose whether the model contained securities or relied upon investment strategies no longer offered by the advisor; and (3) acknowledge, if applicable, that actual results were materially different from those portrayed by the model.[241]

The Commission has also indicated concern about advertisements that obscure the identity of the developer of a particular model, at least where it involved another company. In *In re Cabot Money Management*,[242] the company used a model developed by another corporation with a substantially similar name. The advertising materials did not fully disclose that the model portfolios were developed solely by the other entity. The company also merged actual and model results, "blurring the distinction between the separate performances of [the company] and the other entity."[243] The Commission found this to be a violation of the advertising rules.

The treatment of models illustrates the flexibility of using informal interpretations. The Commission could have embodied the position in the rule. This would have required notice and comment at both adoption and amendment. By relying on no-action letters, however, the staff could simply abandon earlier positions through updated pronouncements with little fanfare or procedural safeguards for the public.

b. Index Disclosure

The use of indices has also generated a number of interpretative issues, with the staff responding by imposing prophylactic disclosure requirements. An index such as the S&P 500 can provide a benchmark for assessing an advisor's performance. The staff has even noted that, in some circumstances, an index would

241. Clover Capital Mgmt., Inc., *supra* note 218. Models are also subject to the requirements applicable to actual results. Thus, results taken from a model must be netted of expenses and be accompanied by disclosure of the effect of any material market or economic condition, the extent dividends and other earnings were reinvested, material conditions, objectives or investment strategies used to obtain the results, and any other disclosure necessary to prevent any false and misleading impression about the model.

242. Investment Advisers Act Release No. IA-1063, 1987 SEC LEXIS 2292 (Mar. 23, 1987).

243. *Id.* A mutual fund timing service using a model failed to disclose that hypothetical investments in other fund combinations generally resulted in lower performance results. In re Managed Advisory Serv., Investment Advisers Act Release No. 1148, 1988 SEC LEXIS 2556 (Dec. 27, 1988). An advisor failed to disclose that half of the six years of performance results contained in an advertisement were from model portfolios when no actual trading occurred. In re Zavanelli, Investment Advisers Act Release No. IA-1077, 1987 SEC LEXIS 3962 (Aug. 17, 1987).

be required in order to put the advisor's performance into accurate perspective.[244]

The staff has, however, stressed the need for full disclosure when using indices. Concern has arisen over the use of an index that differs materially from the particular fund subject to the comparison.[245] This may arise, for example, in connection with indices selected solely to suggest superior performance. At least one court found the failure to disclose distinguishing factors misleading when comparing performance with the Dow Jones Industrial Average.[246]

In *Morill Stanfill*, the staff set forth a list of requirements for the use of indices.[247] The advertisement had to include any facts bearing on the fairness of the comparison. This required disclosure of any significant difference between the investment results of the advisor's portfolio and the relevant index. In determining these differences, the staff noted that the following factors needed to be taken into account: (1) the inclusion of income in capital gains or losses, both realized and unrealized in one of the figures to be compared; (2) the type of security, i.e., equity or debt, composing the account; (3) the object of the account and the stability or volatility of the market prices of the securities in which it is invested;[248] (4) the diversification in the account; and (5) the size of the account.[249]

244. On at least one occasion, the staff has hinted that indices may sometimes be required. *See* Multinational Investments, 1977 SEC No-Act. LEXIS 2367 (Sept. 17, 1977). *See, e.g.*, Oberweis Securities, 1983 SEC No-Act. LEXIS 2650 at *3 (July 25, 1983) ("Finally, we do not believe that Rule 206(4)-1 prevents an investment advisor from publishing an advertisement which states the performance of all recommended securities and compares the performance with the performance of an appropriate index.").

245. *See, e.g.*, In re Killgore Mgmt., Investment Advisers Act Release No. 332, 1972 SEC LEXIS 1514 (Aug. 25, 1972).

246. *See* SEC v. C.R. Richmond & Co., *supra* note 163; *see also* Killgore Mgmt., *supra* note 245.

247. Morill Stanfill, *supra* note 201.

248. *See also* Multinational Investments., *supra* note 244 at *3 ("Where, there are differences between an account and an index with which it is compared in volatility of market prices this too should be mentioned. Otherwise an account which invested in securities that had a high volatility, with respect to that of an index, might appreciate greater than the index during a period when the market was going up and, thus, cause an inference to be drawn about advisory competence would not be drawn at the volatility of the securities in which the account was invested was also stated.").

249. The Commission has sanctioned advisors for comparing performance results to indices "without fully disclosing the similar, dissimilar and other material factors relevant to the comparison." In re Cabot Money Management, Investment Advisers Act Release No. IA-1063, 1987 SEC LEXIS 2292 at *3 (Mar. 23, 1987); *see also* Donaldson Lufkin & Jenrette, 1977 SEC No-Act. LEXIS 625 at *2 (Mar. 2, 1977) ("In this connection, the comparing of the average percentage change in the value of the securities it recommended with the percentage changes in the Dow Jones and S

In a handful of instances, the staff has indicated that the use of a particular index was inappropriate. In *Scientific Market Analysis*, the advertisement compared individual accounts managed by the advisor with the Lipper Mutual Fund Index.[250] The staff noted that the use of the Lipper Index "may not be an appropriate means of comparison because individual advisory accounts are not likely to be as broadly diversified as the portfolio of an investment company."[251]

In general, the staff has not prohibited the use of particular indices. The emphasis has been on proper disclosure. As long as advertisements contain sufficient information to permit accurate comparisons, the staff has generally not interfered with an advisor's choice of index.

4. *Substantive Requirements*

a. Net Fees

The staff has taken the position that advisors may only advertise performance on a net rather than gross basis.[252] Net performance results require the deduction of all fees paid to the advisor. This includes brokerage and other commissions,[253] but not custodial fees paid for the safekeeping of client funds and securities.[254] The Commission has brought actions against advisors for failing to deduct expenses from performance figures.[255]

& P averages may be misleading unless the average volatility of the market prices of the securities recommended . . . was the same as that of the Dow Jones or S & P stock averages. If they are not the same, the differences should be explained.").

250. Scientific Market Analysis, 1976 SEC No-Act. LEXIS 763 (Mar. 24, 1976).

251. *Id. See also* BanCal Mgmt. Corp., 1974 SEC No-Act. LEXIS 942 at *2 (Dec. 4, 1974) (noting that use of Dow Jones Industrial Average or S&P 500 might not be appropriate where advisor's fund had characteristics "substantially different from those of the securities used in calculating" the indices).

252. *See* Clover Capital Mgmt., Inc., *supra* note 218. As the staff explained, "[i]nformation about the fees the advisor charged clients . . . is material to evaluating the investment experience of those clients and the advisor's competence, particularly because . . . fees vary among advisors. Accordingly, advertising actual results on a gross basis may imply, or may lead a prospective client to infer, something about the investment experience of those clients or the advisor's competence that would not be true if the advertisement included information about actual advisory fees and expenses." Investment Co. Inst., 1987 SEC No-Act. LEXIS 2361 at *4 (Aug. 24, 1987). The staff has consistently reiterated the requirement that fees be computed on a net rather than gross basis in a number of administrative proceedings. *See, e.g.*, In re Makrod Investment Assoc., Investment Advisers Act Release No. 1176, 1989 SEC LEXIS 1220 (July 3, 1989); In re Harvest Financial Group, Investment Advisers Act Release No. 1155, 1989 SEC LEXIS 319 (Feb. 21, 1989); In re Managed Advisory Serv., *supra* note 243.

253. Bypass Wall St., 1992 SEC No-Act. LEXIS 102 (Jan. 7, 1992).

254. Investment Co. Inst., *supra* note 252; *see also* Bypass Wall St., *supra* note 253.

255. In re Emory, Investment Company Act Release No. 1283, 1991 SEC LEXIS 1458 (Aug. 6, 1991). To facilitate the monitoring of performance data, the Commis-

Performance results also must reflect actual, rather than model, fees and expenses. In *Securities Industry Association*, however, the staff recognized the difficulty or impossibility of reconstructing past performance data and agreed to permit the use of model fees for historical performance results prior to 1990.[256] Thereafter, advertisements had to include performance data reflecting the deduction of the advisor's actual fees.[257]

The policy of net performance data is eminently sensible. It makes advertisements easier to compare and interpret. The actual position, however, goes beyond the disclosure philosophy of Section 206 and Rule 206(4)-1. The staff rejected suggestions that advisors be allowed to disclose gross performance figures and a schedule of fees in the same advertisement.[258] The requirement for net performance figures, therefore, amounted to a substantive requirement grafted onto the rule.[259]

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sion adopted subsection (a)(16) in 1988. The provision required the retention of all documents, including internal working papers, "necessary to form the basis for or demonstrate the calculation of the performance" for all managed accounts or securities recommendations included in advertisements. 17 C.F.R. 275.204-2(a)(16) (1992). With respect to managed accounts, the retention of account statements reflecting all activity in a client's account would be sufficient. In other words, the adviser did not have to keep "all documents of original entry from which information [was] inputted into an adviser's client accounting system." Recordkeeping by Investment Advisers, Investment Advisers Act Release No. 1135, 1988 SEC LEXIS 1680 (Aug. 17, 1988).

256. Securities Industry Assoc., 1989 SEC No-Act. LEXIS 1177 (Nov. 27, 1989). If the advisor offered more than one fee schedule for a given size account during the period, the "model" fee for each period would be the fee most often selected by clients. If the advisor included performance from different size accounts and periods the appropriate fee for each period would be the highest fee charged during that period to any account included in the performance portrayal.

257. The staff has created one narrow exception to the need for net performance results. The requirement does not apply to certain one-on-one presentations to prospective clients. To fall within the exception, the advisor must provide each client in writing with: (1) disclosure that the performance figures do not reflect the deduction of fees; (2) disclosure that the client's return will be reduced by the fees and other expenses; (3) disclosure that the fees are described in part II of the Form ADV; and (4) a representative example, showing the effect an investment advisory fee, compounded over a period of years, could have on a total value of a client's portfolio. Investment Co. Inst., 1988 SEC No-Act. LEXIS 1761 (Sept. 23, 1988). *See also* Conway Asset Mgmt., 1989 SEC No-Act. LEXIS 87 (Jan. 27, 1989) (restating these requirements). As the staff has indicated, gross performance data may be disclosed where "an investment advisor provides to a prospective client or third-party investment management consultant gross performance results for advisory accounts in a one-on-one presentation that is of a private and confidential nature and is not made to the public through any print, electronic or other medium, provided certain disclosures are made." Bypass Wall St., *supra* note 253 at *4.

258. *See* Investment Co. Inst., *supra* note 252.

259. Despite requests, the staff has indicated unequivocally that it would not "consider[ ] modifying, nor recommending to the Commission that it modify, the interpretive position set forth . . . ." Clover Capital Mgmt., Inc., *supra* note 218 at *7.

b. Predecessor Performance

Predecessor data is another area where the Commission staff has used no-action letters to graft substantive requirements onto the rule. Newly formed advisors operate at an advertising disadvantage. They have no track record to use to induce others to invest. Often, however, the advisor hires experienced money managers. The manager's prior performance represents information of interest to prospective clients and often finds its way into advertisements.

The staff has taken the position that an advisor may use predecessor data if:

(1) no individual other than the successor's portfolio manager played a significant part in the performance of the predecessor's accounts that were transferred to the successor adviser; and

(2) the performance of the predecessor's accounts that were not transferred to the successor adviser did not differ materially from the performance of the transferred accounts.[260]

The staff has essentially interpreted the conditions in a substantive fashion. In *Great Lakes Advisors, Inc.*, the staff declined to permit the use of predecessor performance data where "individuals other than [the money manager with the new company] played a significant role in managing" the accounts.[261] The staff also noted that "disclosure alone" would not be sufficient to render the use of the predecessor performance data not misleading.[262]

5. *Testimonials*

The staff has in place a number of informal interpretations concerning testimonials. In the 1960s, the staff took the position that lists of clients constituted a testimonial.[263] This position was not in the rule, nor was it embodied in no-action letters. The interpretation represented an internal policy enforced through the inspection process. The position apparently arose out of the belief that prospective clients could contact those on the list and receive a favorable review.[264]

260. Great Lake Advisors, Inc., 1992 SEC No-Act. LEXIS 643 at *3 (Apr. 3, 1992); *see also* Fiduciary Mgmt. Assoc., 1984 SEC No-Act. LEXIS 1962 (Feb. 2, 1984); Conway Asset Mgmt., *supra* note 257.

261. Great Lakes Advisors, Inc., *supra* note 260.

262. *Id.*

263. Conversations with Commission staff (Jan. 1993). The author learned of the policy as a result of an inspection of an advisor in late 1992.

264. The staff even took the position that a list of all advisor clients could raise these concerns. A complete list would not, for example, include clients that had

The position was always questionable. The use of lists did not raise the same types of concerns that led to the ban on testimonials. Lists of clients were not inherently misleading or unrepresentative; they did not, "by their very nature," emphasize only the positive.[265] Indeed, properly assembled through objective criteria, client lists provided information of considerable importance.[266] Moreover, the advisor would not be in a position to screen or control the conversations and could not, therefore, ensure that only the positive would be emphasized, the main attribute of testimonial.

The staff eventually and grudgingly abandoned the position, but only when publicly confronted over the issue. In *Denver Investment Advisors, Inc.*, the staff agreed that a list of clients could be included in advertisements. The list, however, could not be formulated through performance criteria. The list also had to contain a disclaimer and disclose the criteria used in formulation.[267]

Similarly, the staff has taken the position that the use of celebrities in advertising constitutes a testimonial. As with client lists, this is not a written policy. The issue only surfaced with the publicity surrounding efforts to stop a high profile advertising campaign by the Franklin Group of mutual funds. The group had used quarterback Joe Montana to promote their funds. After contacts from the SEC staff, the group terminated the campaign.[268]

The staff objected strenuously to his use in the advertisements.[269] They informed Franklin that the campaign violated the rules regulating advertisements by investment companies and investment advisors.[270] Taking a broad position, the staff main-

canceled the services during the relevant period. Conversations with Commission staff (Jan. 1993).

265. Nor do they contain any "implicit or explicit representations or recommendations" concerning the performance of these clients. General Statistics, 1976 SEC No-Act. LEXIS 1755 (Aug. 15, 1976).

266. Disclosing lists of existing clients can help illustrate the expertise, credibility and sophistication of the relevant advisor, much the same way data about the expertise of employees or number of years of operation also illustrates these factors.

267. The disclaimer had to state that "[i]t is not known whether the listed clients approve or disapprove" of the advisor or "the advisory services provided." Denver Inv. Advisors, 1993 SEC No-Act. LEXIS 917 (July 30, 1993).

268. *See* Gail de George, *The SEC Flags Joe Montana*, BUS. WK., Feb. 24, 1992, at 36.

269. The decision on Franklin came to light only because of the high powered nature of the celebrity involved and the power of the Freedom of Information Act ("FOIA"), 5 U.S.C. § 552. The documents relating to the Commission's position with respect to Franklin were obtained pursuant to an FOIA request.

270. Letter from Mary S. Podesta, Associate Director, Division of Investment Management, to Deborah A. Gatzek, Esq., Senior Vice President-Legal, Franklin Group of Funds, Oct. 10, 1991. On file with the author.

tained that any celebrity endorsements in mutual fund advertising violated the securities laws.[271]

The staff maintained that the use of celebrity endorsements was a testimonial in violation of Rule 206(4)-1, even if they appeared in a mutual fund advertisement. Thus, merely using a celebrity in an advertisement, even if the advisor's name was not mentioned, constituted an endorsement of that advisor. The staff did not modify its position even though the celebrity said nothing about the fund directly. "In our view, the appearance of a celebrity in an advertisement constitutes an endorsement whether or not the celebrity has specifically endorsed the Funds."[272]

To the extent that all celebrity promotions were banned, the position went too far. A celebrity's picture should be able to adorn an advertisement to attract attention, similar to the way investment companies commonly use animals or other icons. Furthermore, celebrities ought to be able to provide factual information about the fund, as long as they stop short of any personal attestation.

The informal and unwritten nature of the position has made the staff's precise views unclear. The uncertainty means that advisors are far less likely to use celebrities. The cost of an endorsement coupled with the risk of violating the staff's unwritten policy makes the proposition too risky in most instances.

E. Personal Oversight

As with the Ministry of Finance in Japan, the Securities and Exchange Commission has broad regulatory authority over advisors. The Commission has used the authority to regulate the advertising process, particularly through the adoption of Rule 206(4)-1. In addition, however, the staff has relied upon an informal and highly personal system of interpretation and enforcement. Officials were able to do so in large part because of the absence of effective judicial review of their activity.

The Commission represents the only real source of oversight for advertising practices by investment advisors. A private en-

271. *Id.* ("An advertisement that associates the performance, success or wealth of the celebrity with a fund through name or image is clearly an implied testimonial, whether or not it specifies that the celebrity is an investor in the fund. It is misleading because investors are likely to believe that the celebrity would not be identified with the fund unless the celebrity had information or an opinion about the value of the fund investment. In addition, it implies that the celebrity's wealth and success may be based on investments in the Funds and that an investor could expect similar success if shares of the Funds are purchased.").

272. Letter from Mary S. Podesta, Associate Director, Division of Investment Management, to Deborah A. Gatzek, Esq., Senior Vice President-Legal, Franklin Group of Funds, Dec. 6, 1991. On file with the author.

forcement mechanism for damages under Section 206 does not exist. Notwithstanding the holdings in early decisions[273] and the musings of some commentators,[274] the Supreme Court's decision in *Transamerica Mortgage Advisors v. Lewis*[275] ended the debate on the issue. Finding that Section 206 "simply proscribes certain conduct and does not in terms create or alter any civil liabilities," the Court concluded that the section would not support a private right of action for damages.[276]

Ensuring conformity with rules adopted pursuant to the section, therefore, rests with the bureaucracy, specifically the Division of Investment Management, one of five main divisions within the Securities and Exchange Commission.[277] Assigned to administer highly technical statutes such as the Investment Company Act of 1940 and the Investment Advisors Act, the Division has broad discretion within the agency and does not capture the same level of attention as other divisions addressing issues of higher public profile.

Outwardly, the staff has taken a hands-off attitude toward day-to-day interpretive problems arising under Rule 206(4)-1. Officials have repeatedly refused to "review agreements, advertisements, or other communications that investment advisors in-

273. Abrahamson v. Fleschner, 568 F.2d 862, 876 (2d Cir. 1977); Jones v. Equitable Life Assurance Society, 409 F. Supp. 370, 372 (S.D.N.Y. 1975); Angelakis v. Churchill Management Corp., [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,285 (N.D. Cal. June 6, 1975).

274. *See* Note, *Private Causes of Action Under Section 206 of the Investment Advisers Act*, 74 MICH. L. REV. 308 (1975); Martin E. Lybecker, *Advisors Act Developments*, 8 REV. SEC. REGULATIONS, 927, 934 (Apr. 23, 1975).

275. 444 U.S. 11 (1979).

276. *Id.* at 19. *See also* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 397 (1982) ("We have held explicitly that the language of § 206 does not create an implied damages action."); Universities Research Association v. Coutu, 450 U.S. 754, 772 n.22 (1981) ("In *Transamerica*, the Court refused to imply a private cause of action under § 206 of the Investment Advisers Act of 1940"). The absence of a private right of action may sometimes be circumvented through resort to Rule 10b-5, although the area is not free from controversy. The key difficulty concerns the requirement that the fraud be "in connection with" the purchase or sale of a security. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737-38 (1975). The advertisements will often attempt to induce a client to accept advisory services rather than to engage in specific trades. Any "fraud" therefore may not be in connection with a securities transaction. In some cases, courts have found the "in connection with" requirement to be almost no barrier. *See* SEC v. Wall Street Publishing Institute, 591 F. Supp. 1070, 1088 (D.D.C. 1984). As the court concluded: "[T]he thrust of the magazine is to encourage readers to buy securities; the articles recommend investment, i.e., purchase or sale of the securities of the featured companies. Therefore, in this case, Defendant's false and misleading statements 'touch' securities transactions." *Id.*

277. The principal divisions include: Enforcement, Corporation Finance, Market Regulation, Investment Management, and the Office of the General Counsel.

tend to use in their advisory business."[278] Instead, the principal *public* method for ensuring conformity has been Commission-sponsored litigation and examinations.

The staff has brought a number of enforcement actions, typically administrative proceedings, for violations of the rule.[279] Litigation, however, represents only the most public part of the process. The staff has remained actively involved in reviewing advertisements, relying extensively on more informal and often personal means of regulation. No-action letters have represented the vehicle of choice for articulating broad interpretations, while periodic inspections of investment advisors and their advertisements represent the primary mechanism for ensuring compliance.[280]

In general, no-action letters have been used to articulate broad new policies or shifts in staff interpretation. The requirement that advertisements contain *net* rather than *gross* performance figures represents a recent obvious example. The policies are phrased as interpretations of Rule 206(4)-1, but in reality they often exceed the scope of the provision. By using no-action letters rather than amendments to the rule, the staff obtains flexibility and can subsequently change the position without notice and comment.

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278. Mills-Price & Assoc., 1992 SEC No-Act. LEXIS 858 (July 15, 1992). The staff has consistently refused to review specific advertisements through the no-action letter process. *See, e.g.*, MERITiming, 1990 SEC No-Act. LEXIS 99 at *1 (Jan. 18, 1990) ("As a matter of policy, however, this office does not generally review advertisements that registered investment advisors intend to use in their advisory business.").

279. A LEXIS search conducted on July 11, 1994, revealed 195 enforcement actions, mostly administrative proceedings, citing the rule. Compared with the total number of inspections, however, the staff brings a relatively small number of enforcement proceedings. *See* Richard D. Marshall, *Surviving an Inspection of an Investment Company or Adviser*, INSIGHTS, July 1993, at 19 (noting that less than 3% of advisor inspections result in enforcement proceedings). Enforcement proceedings often arise out of problems that come to light following routine staff inspections, although review of public advertisements represents another common source. As part of a settlement to an enforcement proceeding, the Commission may insist on prophylactic safeguards such as the review of advertisements by an attorney. *See, e.g.*, In re Money Machine, Investment Advisors Act Release No. 783, 1981 SEC LEXIS 359, at *4 (Nov. 12, 1981) (as part of settlement, company agreed to "[e]ngage an attorney to review each specimen advertisement"). Presumably to enhance compliance, the Commission at one time proposed a rule to require written approval of any advisor advertisement by the designated supervisory person. *See* Proposal to Adopt Rule 206(4)-3, Investment Advisors Act Release No. 231, 1968 SEC LEXIS 1325 (Oct. 10, 1968). The proposal was, however, not adopted. *See* Notice of Withdrawal of Proposed Rule 206(4)-3, Investment Advisors Act Release No. 499, 1976 SEC LEXIS 2335 (Feb. 25, 1976).

280. A LEXIS search conducted on July 11, 1994, showed 204 no-action letters citing the rule.

The most comprehensive and personal layer of regulatory review arises out of the system of on-site inspections. The staff periodically inspects advisors.[281] Large advisors in particular can expect regular, even annual, visits from the Division of Investment Management.[282] Advisors must retain copies of all advertisements and they are typically examined during inspections.[283]

Usually conducted by staff in a regional office, inspections ordinarily occur without notice. The staff does not need search warrants; the Investment Advisor's Act provides a plenary right of inspection.[284] An inspection may be routine or "for cause" where a violation is suspected.

Examiners have broad authority to insist on changes in advertisements. The provisions regulating advertisements are exceedingly amorphous. Whether a particular advertisement is misleading, therefore, will often depend upon the personal views of the particular examiner. In general, advisors accept and implement the "suggestions," even if they do not fully agree. Advisors unhappy with the examiner's suggestions have few alternatives other than refusing the advice and risking the damage of public legal proceedings.[285] This Hobson's choice usually

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281. *See* Investment Advisors Act Release No. IA-1093, 1987 SEC LEXIS 3263, at *2 (Nov. 5, 1987) ("As part of the Commission's advisor inspection program, Commission staff routinely examine advisor advertisements for compliance with the advisor advertising rule . . . .").

282. Large advisors are those managing assets in excess of $1 billion. *See infra* note 292.

283. *See* 17 C.F.R. § 275.204-2(a)(11) (1992). Until 1988, they only had to keep copies of advertisements that recommended the purchase or sale of a specific security and were distributed to more than ten persons. *See* Adoption of Reg. § 275.204-2, Investment Advisers Act Release No. 114 1961, SEC LEXIS 783 (May 25, 1961). If the advertisement did not state the reasons for the recommendation, the adviser had to retain a memorandum providing the information. 17 C.F.R., *supra*. This, however, made inspection activity more difficult. The Commission addressed the problem by expanding the category of advertisements that advisers had to retain. *Id.* Essentially, advisers must now maintain, for at least five years, any advertisement distributed to more than 10 persons. The provision does not apply to materials distributed to persons connected to the investment adviser. *Id.* Thus, advertisements do not have to be retained if not distributed to the public. Recordkeeping by Investment Advisers, Investment Advisers Act Release No. IA-1135, 1988 SEC LEXIS 1680 (Aug. 17, 1988).

284. *See* SEC v. Olsen, 354 F.2d 166 (2d Cir. 1965). The Fourth Amendment requirement of a warrant can sometimes be set aside for highly regulated industries. *See* New York v. Burger, 482 U.S. 691 (1987).

285. An effort can be made to obtain redress from the examiner's supervisor. Informal positions may also be appealed to the Commission, although nothing obligates the body to consider the views and it rarely does. In 1992, a company sought redress for the position taken by the staff in a no-action letter concerning proxy proposals. In a highly unusual fashion, the Commission agreed to hear the matter and ultimately reversed the staff. The Commission was in turn reversed by the courts. *See* Amalgamated Clothing and Textile Workers Union v. Wal-Mart, 821 F.Supp. 877 (S.D.N.Y. Apr. 25, 1993).

dictates conformity.[286]

The previously discussed example of testimonials illustrates the process. Examiners objected to the use of client lists, contending that they constituted testimonials. This position emanated from an internal position adopted by the agency staff. The inspection process then became the mechanism for imposing the policy. Although the internal interpretation had been in place since the 1960s, it was not publicly challenged for a quarter of a century.

IV. COMPARISONS

The approach to advertising in the two countries initially seems quite different. In Japan, administrative agencies have extraordinarily broad discretion. The governing statutes typically contain nothing more than an outline. Interpretation and gap filling has been deliberately left to the Ministry of Finance. As a result, the statutory framework imposes few restraints on Ministry positions.

Regulation is highly personal and informal. Advisors are governed primarily through informal interpretations by MoF. While MoF has issued a circular and an ordinance that address advertisements, the positions did not require notice and comment and can be changed at any time. Unwritten policies predominate, including the ban on comparative advertisements.

In contrast, the United States appears to have a more legalistic, transparent approach. Regulations are embodied in rules; rules that cannot change without adequate procedures, particularly notice and comment. Even informal positions seem more transparent, appearing in no-action letters and other readily accessible writings.

The system in the United States has a less personal, less intrusive hue. The staff has refused to review specific advertisements, leaving the matter to the discretion of the advisor. Advisors, therefore, have broader latitude, subject only to intervention by the Commission in relatively extreme circumstances. Even when litigation ensues, courts typically engage in an exacting review, making certain that the staff's positions remain consistent with the applicable statute and rules.

These differences, however, recede upon closer scrutiny. Under both schemes, the relevant administrative agency has broad regulatory discretion. Interpretative positions have become unmoored from their statutory framework. The reigning

286. *See* Marshall, *supra* note 279, at 19 ("Finally, do not fight over details. A registrant that flatly refuses to make minor changes in response to a deficiency letter may find itself under investigation by the SEC's enforcement attorneys.").

enabling act has little relevance to the regulatory scheme and does not impose significant restraints. In the case of the Securities and Exchange Commission, even the text of Rule 206(4)-1 has provided little guidance, having been overtaken by a raft of administrative interpretations.

The SEC and MoF both seek to implement their own version of regulation, unaffected by legislative design. MoF has attempted to limit "harmful" competition; the Commission has insisted upon uniformity in advertisements. Both rely on a high level of personal, largely unreviewable interpretation, with informal, often unwritten, interpretations predominating. The positions, to the extent they are reduced to writing, typically take the form of no-action letters or circulars, both susceptible to unilateral revision by the agency. Interpretations are just as likely to be oral, whether a ban on comparative advertisements or a ban on client lists. MoF uses daily contact with advisors, including a system of pre-clearance. The Commission relies on inspections. In both countries, therefore, personal contact and oral advice represent critical components of the regulatory process.

Judicial challenges to staff interpretations are rare, bordering on nonexistent. No advisor has ever sued the Ministry of Finance. While litigation in the U.S. seems ubiquitous—particularly given the large number of enforcement proceedings—the reality is quite different. Private suits in the area rarely occur. The Commission does bring a modest number of enforcement proceedings, particularly at the administrative level. These suits, however, inevitably settle. In the absence of adversarial proceedings, the resulting opinions contain only the staff's views.

No advisor in the United States has ever sued the Commission over a position taken in a no-action letter concerning advertisements.[287] Instead, challenges have only arisen as a defense in the small number of suits brought by the Commission that were actually litigated rather than settled.[288] In other words, staff interpretations remain largely beyond the scope of judicial review.

Those wishing to resist staff views on advertisements have few effective avenues of appeal. In general, they studiously avoid litigation with the Commission. Expense is a factor. More im-

287. Because no-action letters reflect the views of the staff rather than the Commission, it may not even be a final agency action subject to judicial review. *See* Massachusetts v. Franklin, 112 S. Ct. 3019 (1992). *See also* Amalgamated Clothing and Textile Workers Union v. SEC, 15 F.3d 254 (2d Cir. 1994) (SEC position expressed in no-action letter was not a final agency decision for purposes of appeal under the Administrative Procedures Act).

288. The most common challenges to Commission authority in this area have centered on the relationship between the regulation of advertisements and the First Amendment. *See* Lowe v. SEC, 472 U.S. 181 (1985).

portantly, however, violations of subsection (a)(5) of Rule 206(4)-1 essentially involve fraud, a charge that may well scare away clients and otherwise damage business. This encourages accommodation and, once enforcement proceedings have been instituted, settlement.

Even the most noticeable *differences* in the two systems recede with closer scrutiny. The Commission adopted Rule 206(4)-1 to regulate advertisements, relying on notice and comment under the APA. MoF, in contrast, relied on a circular or similar device that can be changed at will. In adopting the circular, however, MoF sought comments, although more informally, and would do so again before implementing any significant changes. Moreover, the distinction overstates the importance of Rule 206(4)-1. Most of the staff's recent positions have arisen out of informal interpretations, particularly no-action letters. As with circulars in Japan, they can be changed at any time without notice and comment.

In many respects, therefore, the staff at the Division of Investment Management has responded in ways similar to the Securities Bureau within the Ministry of Finance. Officials have taken advantage of broad amorphous mandates to shape industry behavior. They have also gone beyond their statutory authority, confident that advisors will not challenge the behavior. In some respects, MoF has a tougher time altering informal policies with a consensus necessary before positions can shift. The Commission labors under no comparable limitation.

The U.S. system of notice and comment is more inclusive than in Japan. Policies promulgated by MoF have typically been determined by relevant regulators and affected industries. Other groups were excluded from the process, particularly consumers. Pressure is growing in Japan to give consumers a greater voice in the policy making process.

The notice and comment process in the United States gives all interested parties an opportunity to comment and participate. Yet this difference should not be overstated. In Japan, as other groups insist on a place at the table, MoF has made some moves toward inclusion. More directly, although anyone can comment, U.S. agencies have considerable freedom to disregard the views. Unlike Japanese agencies, they are not bound by the need for a consensus. Indeed, with some U.S. agencies considered captives of the industry they regulate, the views of other groups would probably carry little weight.[289]

289. Agencies must account for significant comments when promulgating a rule. *See supra* notes 10, 11. In general, however, this does not impose any affirmative obligations on the agency to accept comments. Instead, the agency need only have a

In particular, it is hard to say consumers and other non-industry groups have had much influence on policy formulation over rules governing advertisements. Rule 206(4)-1 was adopted in 1961 and has remained unamended. Despite all of the policy shifts over the last thirty years, consumers and other groups have had little opportunity to participate.

That does not, of course, mean that the two systems are identical. Practices seem more uniform in Japan. This is not, however, attributable to culture or superior bureaucratic acumen. There is a more basic explanation. Japan has only a fraction of the advisors existing in the United States.[290] Regulators can therefore exercise greater oversight, although that may change as the number of advisors continues to increase.

The entire licensing process in Japan also enhances bureaucratic authority. Advisors wanting to manage pension assets must obtain a discretionary license, a difficult and expensive endeavor. MoF has used the process to micro-manage the advisory business down to the floor plan of the office and the fees charged. Licensing has been used effectively to keep down the number of advisors with discretionary authority.[291]

The United States does not have a comparable licensing process. Advisors need only register, without having to obtain Commission approval. Easier access has had the predictable effect. The United States has almost thirty times the number of advisors as Japan. As a practical matter, therefore, the Division of Investment Management cannot exercise the same level of personal scrutiny.[292] Opportunities for micro-management are, concomitantly, less.

The other principal distinction concerns limitations on operations. Japanese advisors have only limited access to pension plan assets. They cannot engage directly in mutual fund manage-

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rational explanation for why the comment was disregarded. *See, e.g.*, American Textile Manuf. Inst. v. Donovan, 452 U.S. 490 (1981).

290. Compare *infra* notes 291 and 292.

291. Japan, in contrast, has 592 companies registered as advisors, 155 with discretionary licenses. JAPAN SECURITIES INVESTMENT ADVISORS ASSOCIATION, INVESTMENT ADVISORY SERVICES IN JAPAN. Licensing authority has been used effectively in other parts of the financial system. *See supra* note 122.

292. In 1990, the staff had only 36 inspectors for 17,000 advisors. *See* GENERAL ACCOUNTING OFFICE, INVESTMENT ADVISOR: OVERSIGHT IS INADEQUATE FOR INVESTOR PROTECTION, GAO/T-GGD-92-46 (June 4, 1992). The staff was only able to inspect about 1,200 advisors, concentrating on those managing assets of more than $1 billion. *Id.* For smaller advisors, the examination cycle is one inspection every 30 years. A survey of key cities with a heavy concentration of advisors showed that in any given year 60% had never been inspected. *See* HOUSE REP. NO. 102-883, 102d Cong., 2d Sess. 16 (Sept. 22, 1992).

ment.[293] With respect to pension plans, the limitations seem to have a bureaucratic explanation. The Banking Bureau within MoF has resisted the continued erosion of the quasi-monopoly over pension plan management held by trust banks and insurance companies.

The behavior may be pure parochialism. The Banking Bureau has little interest in seeing the adoption of policies that harm industries under its jurisdiction. The policies also have a more direct prudential explanation. Trust banks have been buffeted by the recession in Japan, with some possibly insolvent.[294] In the postwar era, no bank in Japan has ever failed. Continued erosion of one of the few remaining profitable areas of trust banking activity would increase the risk of insolvency, something no Banking Bureau official wants to see happen.

V. CONCLUSION

In the context of advertising by investment advisors, the bureaucracies in the two countries act in a surprisingly similar fashion. Given comparable factors—particularly a broad statutory mandate and an absence of judicial or political review—the behavior of officials in the two countries have converged. Officials have become very involved in industry affairs and exercise a highly personal level of oversight. This indicates that the differences in the two systems are not a result of immutable characteristics such as culture and history but can be better explained by ordinary modes of bureaucratic behavior.

This article does not suggest that the two systems operate in an identical fashion. Far from it. They do not have the same approach toward regulation. MoF officials remain involved in almost all facets of advisory activity. While the Securities and Exchange Commission sometimes engages in a similar level of oversight, such as in the case of advertisements, the approach is not prevalent. Indeed, the regulation of advisor advertisements in the United States seems unusual. It constitutes an area that has escaped judicial review and involved an inordinate level of administrative discretion.

Nonetheless, even the occasional convergence of the two systems is instructive. Bureaucracies have certain characteristics and behavioral patterns that transcend national boundaries. This dispels some of the mystery surrounding Japanese bureaucratic behavior. MoF does not act in a uniquely "Japanese" fashion,

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293. An investment trust manager can hire an advisor but doing so entails a fee split.

294. *See Japan's Trust Banks; Shakier Than They Should Be*, ECONOMIST, Feb. 13, 1993, at 74.

but the way any bureaucracy would act given such a high level of unsupervised discretion.

In terms of reform, an issue of great importance to the foreign advisory community in Japan,[295] the lesson learned is more pessimistic. This article suggests that the high level of Ministry intrusion into the financial markets has a number of structural causes. They range from the absence of effective judicial review to the absence of limitations in the enabling act. This suggests that a reduction in regulatory intervention in the financial markets will not be easy to achieve over the short term and not without significant changes in the way policy decisions are made in Japan.

295. *See supra* note 135.