

**Securities Industry Association**

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December 23, 1996

Mr. John Pinto  
Executive Vice President  
NASD Regulation Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006

**Re: NASD Notice to Members 96-60**

Dear Mr. Pinto:

On behalf of the Securities Industry Association ("SIA")<sup>1</sup> I wish to bring to your attention a problem with respect to a recent Notice to Members. Notice to Members 96-60<sup>2</sup> ("NTM 96-60") was intended to serve as a supplement to an earlier Notice to Members<sup>3</sup> and to further clarify member firms' suitability obligations to customers. While sympathetic to and supportive of the efforts of NASD Regulation Inc. ("NASDR") to clarify the scope of a member's suitability obligation, and sharing NASDR's concern about inappropriate customer transactions in "speculative and low-priced securities," we believe that NTM 96-60 has failed in its purpose, and unintentionally obscured the nature of a member firm's suitability obligations. In addition, if the language of NTM 96-60 with respect to what constitutes a "recommendation" is allowed to stand, it will create the possibility of significant competitive inequality between banks and securities firms.

The chief difficulty with NTM 96-60 stems from the final paragraph. It appears designed to express the view that the scope of transactions that will be viewed by NASDR as having been "recommended" is not coextensive with those that are "solicited."<sup>4</sup> The concluding sentence presents the primary problem:

In particular, a transaction **will** be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication. In our view, this statement is an unprecedented expansion of the suitability obligations of member firms, creating a completely unworkable regulatory standard. <sup>6</sup> We find it surprising that such a view should first appear in a Notice to Members without providing the opportunity for input by member firms, particularly in the wake of the recent extensive work by the NASD's Board and Fixed Income Committee on this subject in the context of institutional customers. <sup>7</sup> Read literally, the language from NTM 96-60 would trigger a securities firm's suitability responsibilities for every transaction where the firm or its employees had previously communicated *any* information regarding that security to the customer. It is imperative to draw a distinction between actions

that constitute inviting a customer to undertake a transaction after having supplied that customer with a carefully considered proposal, and doing no more than engaging in discussions with customers (or potential customers) concerning various investment alternatives available in the market, or supplying routine financial information, etc. <sup>8</sup> Simply supplying the firm's view of a given security or transaction should not constitute a "recommendation" under the Suitability Rule.

In addition, as you know, the banking regulators are in the process of adopting sales practice regulations for banks that are brokers or dealers in government securities.<sup>9</sup> However, they clearly have a very different view as to what constitutes a recommendation. For example, in the release containing their proposed suitability rule (modeled on the NASD's) they specifically requested comment on whether the scope of what was excluded from the term "recommendation" needed to be further clarified:

In particular, is it sufficiently clear that the provision of market observations, forecasts about the general direction of interest rates, other descriptive or objective statements concerning government securities or the government securities markets, or price quotations would not be considered to constitute making a 'recommendation' concerning a government security, absent other conduct?<sup>10</sup> The difference with NTM 96-60 is striking; under the standard outlined in NTM 96-60, merely making "descriptive or objective statements" to a customer about a security would be viewed -- after the fact -- as having created a suitability obligation for the broker-dealer for transactions subsequent to the communication.

While the banking regulators have yet to finalize their suitability rule, we believe that the language quoted above indicates their decision to adopt an approach to determining what constitutes a "recommendation" greatly at odds with the view outlined in NTM 96-60. If they adopt such a rule and NTM 96-60 is not modified, it will result in banks having a considerable competitive edge in complying with their suitability obligations. Since we believe it essential that banks and securities firms operate under a genuinely comparable regulatory scheme, we believe that NASDR must take action to prevent this bifurcation of suitability standards.

Previously, NASDR has resisted defining "recommendation," asserting that "defining the term 'recommendation' is unnecessary and would raise many complex issues in the absence of the specific facts of a particular case."<sup>11</sup> However, NTM 96-60 represents the second time that NASDR has failed in attempting to clarify what constitutes a "recommendation" in the suitability context. Thus, we respectfully request that NASDR re-consider its decision not to define "recommendation" in this context. <sup>12</sup> Failing that, we request that NASDR undertake a more comprehensive effort to clarify the scope of the term so as to ensure that it is in accord with prevailing industry practice.

SIA appreciates the opportunity to provide its views to NASDR on this important issue and would welcome the opportunity to discuss this matter further.

Sincerely,

Stuart J. Kaswell  
Senior Vice President and General Counsel

cc:

Federal Regulation Committee  
OTC Derivative Products Committee  
Self-Regulation & Supervisory Practices Committee  
Executive Committee, C & L Division

## Footnotes

<sup>1</sup> The Securities Industry Association is the trade association representing more than 750 securities firms headquartered throughout North America. Its members include securities organizations of all types--investment banks, brokers, dealers, specialists, and mutual fund companies. SIA members are active in all markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities industry's revenue in the United States.

<sup>2</sup> NASD Notice to Members 96-60 (September 1996).

<sup>3</sup> NASD Notice to Members 96-32 (May 9, 1996).

<sup>4</sup> In our view, a "recommendation" generally should be viewed as entailing considerably more than a mere "solicitation." The latter may involve no more than an invitation to engage in a particular transaction by the securities firm, whereas when a firm makes a "recommendation," it represents a proposal individually tailored for a particular customer in the expectation that it will be relied upon.

<sup>5</sup> NTM 96-60, p. 2 (emphasis in original).

<sup>6</sup> The requirement would be particularly inappropriate in the case of institutional clients, most of whom have easy access (either internally or otherwise) to advice from a variety of investment professionals.

<sup>7</sup> See the work on the NASD's institutional suitability interpretation evidenced in *NASD Notice to Members 94-62 (August 1994)*; *NASD Notice to Members 95-21 (April 1995)*; *SEC Release No. 34-36383 (October 23, 1995)*; *SEC Release No. 34-38973 (March 14, 1996)*.

<sup>8</sup> Indeed, the very concept of "suitability" would lose its meaning if applied in this wider context. In such a case, NASDR would essentially be asking member firms to determine if it was "suitable" to relay particular information to a client. This is so because NTM 96-60 would create retroactive suitability obligations. At the time of even a completely unsolicited transaction, a firm would have a suitability obligation if at any point in the past the firm had supplied any information that would serve to identify the particular security involved in the current transaction. We suspect that neither member firms nor their customers would welcome the chilling effect upon communications with customers resulting from such a provision. In addition, as discussed below, the inequality between securities firms and banks would be palpable.

<sup>9</sup> The proposed rule and interpretation appear at 61 FR 18470 (April 25, 1996).

<sup>10</sup> 61 FR at 18472.

<sup>11</sup> SEC Release No. 34-37588; 61 FR 44100 (August 27, 1996).

<sup>12</sup> In responding to the NASD's initial proposed suitability interpretation in 1994, SIA's comment

letter suggested the following as a definition: "[A] considered proposal for a specific customer based upon information supplied to the firm for the purpose of enabling a securities firm to make a recommendation in the expectation that it will be relied upon." Letter to Joan C. Conley from SIA's Federal Regulation and Self-Regulation and Supervisory Practices Committees, October 17, 1994.