



Securities Industry Association

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Re: Notice and Draft Interpretive Guidance on Dealer Responsibilities in
Connection with Both Electronic and Traditional Municipal Securities
Transactions

The Securities Industry Association (“SIA”)¹ is pleased to offer its comments in response to the Notice and Draft Interpretive Guidance on Dealer Responsibilities in Connection with Both Electronic and Traditional Municipal Securities Transactions (“the draft guidance”). Specifically, the SIA is concerned about Rule G-19: Suitability of Recommendations and Transactions. First, the language suggests that posting a list of municipal inventory on a website is a recommendation of everything on the list to every customer who can access the site. Second, the draft guidance suggests that broker dealers may have an affirmative obligation to screen each customer and allow access to only that part of the inventory that is deemed to be suitable for that particular customer. SIA believes that the draft guidance may unjustifiably expand the commonly held views of what a recommendation is and what the suitability obligation entails. Furthermore, requiring suitability reviews for the kind of information that investors are increasingly demanding from their firms will ultimately result in less overall information and increased dependence on less reliable sources of information from unregulated entities.

¹ The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than \$300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: <http://www.sia.com>.)

SIA believes that the analysis misses the principal focus of the suitability analysis - the contents of the particular communication at issue. The discussion portion of the draft guidance seems to blur the concept of a recommendation from which the suitability obligation derives. The release states that "whether a dealer is making a recommendation will depend on the facts and circumstances, specifically including the sophistication of the customer and the nature of the relationship between the dealer and the customer" and "the fact that the dealer is operating an alternative trading system and has expressly limited its agency obligations may be significant."

The Clarification of Statements was timely and welcome, but is only partially helpful. On the one hand, we find helpful the statement that the MSRB did not intend to expand the generally accepted definition of recommendation in the context of suitability rules and that the MSRB intends to be consistent with existing customer suitability analysis. However, the MSRB also states that by including the sophistication of the investor and the nature of the relationship with the firm as relevant facts for consideration, "the MSRB intended to provide more leeway to the analysis of the facts and circumstances, rather than less." If more leeway means emphasizing those factors at the expense of the contents of the communication, then the MSRB guidance will be expanding the definition of suitability despite statements to the contrary.

SUITABILITY APPLIES ONLY TO RECOMMENDATIONS

Suitability obligations, and the law imposing them, focus on the broker-dealer's message to the customer; namely, whether the broker has advised a particular customer to purchase a specific security. The type of broker-dealer and the channel or medium of communication has always been incidental to the analysis. There is no legal or policy justification to deviate from this longstanding approach in order to create special rules for brokers who use efficient and convenient electronic means for communicating with and delivering information to their customers.

The NASD's suitability rule, Rule 2310, imposes suitability obligations only in the context of individually-tailored recommendations. Rule 2310 states, in relevant part: "In *recommending* to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is *suitable for such customer*." Thus, a broker-dealer has no obligation to determine whether a customer's investment is suitable for that customer unless the broker-dealer has made a specific recommendation of that security to that customer.² The NASD recently reaffirmed this point in Notice to Members 99-11, which stated that "firms' suitability obligations *in*

² See, e.g., *Parsons v. Hornblower & Weeks-Hemphill Noyes*, 447 F.Supp. 482, 495 (M.D.N.C. 1977), *aff'd*, 571 F.2d 203 (4th Cir. 1978) ("the NASD suitability rule requires that a broker act in accordance with his knowledge of the customer's financial capabilities only when he *recommends* the purchase, sale or exchange of any securities").

*connection with recommended transactions . . . [do] not depend upon whether a trade is executed on-line or otherwise.”*³

The SEC has taken the same position. Even in connection with the most speculative of securities—penny stocks—under SEC rules a broker-dealer has no suitability obligations in the absence of a recommendation.⁴ Other suitability rules, and the case law imposing suitability obligations under Rule 10b-5, are in accord.⁵ Although the NYSE’s “know your customer” rule, Rule 405, is not explicitly triggered by the making of a recommendation, we are not aware of any authority imposing suitability obligations under Rule 405 in the absence of an individualized recommendation.⁶ Were the NYSE to attempt to dramatically reinterpret Rule 405 to impose a suitability obligation in the absence of a recommendation, it would have to obtain SEC approval under Section 19(b) of the Exchange Act.

These rules are consistent with the origins of the suitability doctrine in the “shingle theory.” The “shingle theory” provides that, by hanging out its “shingle,” a broker implicitly represents, among other things, that when it recommends a security to a specific customer, it has determined that the security is suitable for that customer in the light of that customer’s particular financial situation and investment objectives. Accordingly, when the broker does not make such a recommendation to a customer, it makes no such implied representation, and therefore has no obligation to determine suitability.

Customer expectations are also central to this facts and circumstances determination. Customers understand that information obtained through a broker-dealer Web site does not constitute an individualized recommendation. There is neither an explicit nor an implied representation that any securities discussed on the Web site are appropriate

³ NASD Notice to Members 99-11, n.3 (January 26, 1999). While Schwab concurs with the statement that suitability obligations apply to recommended transactions no matter how those transactions are executed, we note that we are not aware of any broker-dealers that are currently conducting activities that could be considered to constitute individualized recommendations over their Web sites.

⁴ See Exchange Act Rule 15g-9(c)(1) and 15g-1(e) (exempting from suitability requirements of penny stock rule “transactions that are not recommended by the broker or dealer”).

⁵ See, e.g., SEC Release No. 34-27160 (Aug. 22, 1989) (“the NASD and other suitability rules have long applied only to “recommended transactions”). See also *Hill v. Bache Halsey Stuart Shields, Inc.*, 790 F.2d 817, 824 (10th Cir. 1986); *Unity House, Inc. v. North Pacific Investments, Inc.*, 918 F.Supp. 1384, 1392 (D.Hawaii 1996); *Chee v. MNE Midland Bank, N.A.*, [1990-91 Transfer Binder] CCH Fed.Sec.Law Rptr. ¶95,806 (E.D.N.Y. 1990); *Peterson v. Securities Settlement Corp.*, 226 Cal.App.3d 1445, 1456 (1991). See generally N. Wolfson, R. Phillips, & T. Russo, *Regulations of Brokers, Dealers and Securities Markets* (“Wolfson on Regulation”), ¶2,08[1], at 2-33 to 2-34 (1977).

⁶ See Wolfson on Regulation ¶2.08[1] at 2-33 (“[a]s interpreted over the years [Rule 405] has served as protection for customers against unsuitable *recommendations*”) (emphasis added).

investments for that specific customer or that the firm is in any way assessing or advising the customer on investment choices. To the extent that any information on a broker-dealer's Web site could be considered an endorsement of a particular investment (*e.g.*, research reports with "buy" ratings, stock rankings, etc.), it is clear that they are general endorsements and not recommendations made to specific investors.

Thus, under existing suitability rules, suitability obligations arise only in connection with a recommendation that a specific security is suitable for a particular customer.

INVENTORY LISTS ARE NOT RECOMMENDATIONS

Moreover, the SIA is concerned that de-emphasizing the contents of a communication in determining what is a recommendation will result in suitability reviews for many types of non-recommendations. The draft interpretive guidance states that "it is possible that a retail customer will believe that a dealer that sends its [inventory] listing to its customers is making a recommendation." The clarification states that "depending on the totality of the relevant facts and circumstances, sending [a list of inventory] might (but would not necessarily) constitute a recommendation." This leaves open the possibility that the act of making an inventory list available to a customer over the web, without any accompanying communication, could be deemed a recommendation. SIA believes that this too would represent an expansion of the generally accepted definition of recommendation in the context of the suitability rules.

Web site information constitutes general advertising and research that does not give rise to a customer-specific suitability obligation. Information available through a broker-dealer's Web site is closely akin to generally available advertising or research reports, in which securities may be ranked and specific securities may be identified as worthy of consideration. Indeed, this kind of information has been made available to customers in hard copy for many years. However, as the disclaimers in these reports routinely confirm, these endorsements do not constitute individualized recommendations.

Regulators have consistently recognized that the distribution of general, impersonal advertising material does not, in itself, give rise to suitability obligations on the part of the broker. The Unger Report reaffirmed this position. In discussing a hypothetical in which a customer pulls information off the broker's Web site, such as research reports or market commentary, the report notes that "[t]his type of activity should not trigger customer-specific suitability requirements."⁷ This is consistent with other SEC statements over the years. In connection with its (now rescinded) general suitability rule the SEC emphasized that "it is not intended that a general distribution of a market letter, research report or other similar material would in itself constitute a

⁷ "Online Brokerage: Keeping Apace of Cyberspace." Report of Commissioner Laura S. Unger to the U.S. Securities & Exchange Commission. (November 1999).

recommendation within the meaning of this rule.⁸ Similarly, in connection with its penny stock rule, the SEC refused to extend suitability obligations to "general advertisements not involving a *direct recommendation to the individual*."⁹

The NASD has also recognized this principle. In 1995, the NASD amended Rule 2210, governing "Communications With the Public," to include within the definition of advertisements "material published, or designed for use in, . . . electronic or other public media"; and to include as sales literature any other "written or electronic communication distributed or made generally available to customers or the public, . . . includ[ing] research reports, market letters, [and] performance reports."¹⁰ While Rule 2210 contemplates that certain advertising and sales material, including generally available electronic communications, can constitute a recommendation, the obligations imposed thereby do not extend to suitability but rather only to having "a reasonable basis for the recommendation," making certain disclosures and providing certain information.¹¹

CUSTOMERS ARE ADEQUATELY PROTECTED BY EXISTING RULES

Imposing suitability obligations is unnecessary in the light of the extensive protections provided by other aspects of the overall regulatory framework of the securities laws and the rules and regulations of the SEC and the SROs.

First, as the NASD has pointed out, "all communications with the public, regardless of the medium, are subject to the antifraud provisions of the federal securities laws, SEC rules, and NASD Rules."¹² A broker-dealer that makes material misrepresentations in information it provides on its Web site is exposed to the possibility of liability for civil damages and/or regulatory sanctions under various anti-fraud laws.

Second, when a broker makes a generalized, impersonal recommendation to the public at large, even though it has no obligation to determine whether the recommendation is suitable for a particular customer, it nonetheless retains "the obligation related to suitability that requires that a member have . . . a 'reasonable basis' to believe that the

⁸ SEC Release No. 34-8135 (July 27, 1967).

⁹ SEC Release No. 34-27160 (Aug. 22, 1989) (emphasis added); see Exchange Act Rule 15c-9.

¹⁰ NASD Rule 2210(a)(1), (2).

¹¹ NASD Rule 2210(d)(2)(B).

¹² Notice to Members 96-50.

recommendation could be suitable for at least some customers."¹³ Similar requirements are contained in NASD Rule 2210(d)(2) and NYSE Rule 472.40, which also require that a member "must have a reasonable basis" for a generalized recommendation.

Third, as noted, most electronic communications that are generally available to customers or the public constitute "communications with the public" subject to NASD Rule 2210 and NYSE Rule 472. They accordingly are subject to the requirements, among others, that they be approved prior to use by a registered principal and, in some cases, filed with the NASD; that they contained no exaggerated, unwarranted, false or misleading statements or unwarranted claims or superlatives; and that they omit no material facts causing the material to be misleading.¹⁴ Moreover, to the extent that research reports or other material provided on a broker-dealer's Web site constitute general recommendations, the SROs require the firm to make disclosures about whether it is a market-maker in the security, whether it trades as a principal in the security, whether it or its officers own the security or options on the security, whether the firm has recently acted as manager or co-manager for the issuer of the security, and whether the firm has any directors on the board of the issuer.¹⁵

Thus, providing information on a Web site is already subject to the full panoply of protections provided by the securities laws and the regulatory scheme. There is no need to impose an additional requirement of suitability review.

MSRB POLICIES SHOULD ENCOURAGE DISSEMINATION OF INFORMATION

Technological advances enabling widespread access to the Internet have dramatically changed the realities of investing for individual investors by allowing unparalleled access to information and prompt and inexpensive methods of trading. SEC Chairman Arthur Levitt Jr. has characterized the Internet as "a powerful tool in helping establish a 'level playing field' for all investors, large and small":

Information and ideas are flowing constantly over an affordable, accessible system – giving individuals the same access to market information as large institutions. The Internet is a supremely powerful force for the democratization of

¹³ Release No. 34-37588 (Aug. 20, 1996) n. 19.

¹⁴ Rule 2210(a), (b), (d)(1); see Notice to Members 95-74; "Ask the Analyst About Electronic Communications," NASD Regulatory & Compliance Alert (April 1996).

¹⁵ NASD Rule 2210(d)(2)(B)-(C); NYSE Rule 472.40(2).

our marketplace: For anyone with a computer and a modem, the Internet ensures timely access to accurate data.¹⁶

Regulators should take care not to impede the significant advances these new technologies have made for individual investors. The industry has raised special concerns about the chilling effect of imposing suitability obligations on providers of impersonal information and the potential liability that it would entail. Requiring suitability review simply because securities are brought to the attention of an investor would deter communications. "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."¹⁷ The effect of a contrary rule would be to force investors out to Web sites run by unregulated entities, which are not subject to SRO rules governing communications with the public – a result that neither our regulators nor the industry should desire.

CONCLUSION

Changes in technology need not require us to alter our traditional notions of the duty we owe to customers. The mere fact that technology permits more and different kinds of information to be available to customers should not automatically result in more information coming under this duty. Suitability should continue to depend on the existence of a recommendation, and a recommendation should continue to be found where a broker dealer has advised a customer to purchase (or sell) a particular security. The MSRB should make clear that the most important factor in determining a recommendation is the content of the communication.

Information about individual municipal securities can be hard to come by, and there may also be little information about the market in which these securities trade. The MSRB's goal should be to adopt policies that encourage the dissemination of more objective (non-advice) information. However, the language of the MSRB's guidance shows a willingness to expand the kinds of communications it considers to be a recommendation. Moving the standard above and beyond the reasonable expectations created by the plain language of the communication at issue will create more uncertainty on the part of firms seeking to provide this information. That uncertainty combined with the logistic impossibility of customizing a general posting for each

¹⁶ "Investor Protection in the Age of Technology," Remarks by Chairman Arthur Levitt, Jr., U.S. Securities and Exchange Commission, Salt Lake City, Utah, March 6, 1998 (available at www.sec.gov/news/speeches/spch205.txt) ("Levitt Address").

¹⁷ SIA 1996 Comment Letter n.8.

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individual customers will ultimately cause broker-dealers to make less information available to investors.

To the extent such contacts have not already taken place, SIA believes that MSRB should consult with NASDR on the issue of suitability before considering further action. NASDR has extensive experience regulating in this area and coordination and consistency among the various regulators would be of enormous benefit to the industry. We welcome the opportunity to discuss our views in greater detail. If you have any questions, please contact Scott Kursman, Associate General Counsel, at 212-618-0508.

Very truly yours,

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