



Securities Industry Association

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October 9, 2002

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

**Re: NASD Notice to Members 02-51; Proposed Amendments to NASD Rule
2210(d)(2)(N) (Predictions and Projections)**

Dear Ms. Sweeney:

The Online Brokerage Legal, Technology & Regulation and Self Regulation and Supervisory Practices Committees (the "Committees") of the Securities Industry Association ("SIA")¹ appreciate the opportunity to comment on the National Association of Securities Dealers, Inc.'s ("NASD's") proposed Interpretive Material to NASD Rule 2210(d)(2)(N), as set out in Notice to Members 02-51 ("NTM 02-51"). The proposed Interpretive Material would provide a limited exception to Rule 2210(d)(2)(N) allowing member firms to provide customers direct access to investment analysis tools under limited circumstances.

The Committees support the NASD's effort to update its rules to accommodate new technology and to recognize the potential value of investment analysis tools to the investing public. The SIA agrees with the NASD that, with appropriate disclosures and other safeguards, investors can properly use these tools to make judgments about investments. Unfortunately, in the process of trying to loosen its rules to accommodate such products, the NASD has actually interpreted more broadly the scope of the general rule/prohibition to which the proposed exception would apply. Specifically, discussion in the NASD proposal suggests that the current rule includes a blanket prohibition against

¹ The Securities Industry Association brings together the shared interests of more than 600 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 nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the U.S. (More information about SIA is available on its home page: <http://www.sia.com>.)

tools that include forecasts or predictions. This characterization of the present NASD rule has resulted in much confusion on the part of member firms because it appears to contradict other statements, interpretations and rule language, including the rule's stated purpose of ensuring that communications related to these tools are "fair, balanced, and not misleading." Finally, a broadened application of the prohibition has the effect of making the well-intended exception seem exceptionally narrow, unnecessarily burdensome to comply with, and of marginal value.

SIA believes the Interpretive Guidance ought to offer a non-exclusive safe harbor on the condition that members who offer the tools make appropriate disclosures. This would permit the development and deployment of tools for use by investors, eliminate the need for review of the application of complex mathematical and statistical principles, and harmonize the approach with existing guidance from the NASD and other regulators. In addition to the safe harbor approach, SIA recommends that the NASD:

- Clarify certain characterizations in the Interpretive Material of the existing rule;
- Refine the definition of "investment advisory tools";
- Eliminate the requirement to file investment analysis tools and related sales material with the NASD;
- Limit any required disclosures for investment analysis tools to information that would be appropriate to providing a fair and balanced presentation of information to an investor using such a tool;
- Eliminate the requirement to include mandated disclosures in sales material; and
- Clarify the extent of a member firm's responsibility for investment analysis tools; and
- Provide a form of disclosure that member firms may use with investment analysis tools, while allowing member firms to provide alternative disclosures that are substantially similar.

Each of our recommendations is discussed in turn below.

Background

Rule 2210(d)(2)(N) provides that, in communications with the public, "investment results cannot be predicted or projected." The rule makes clear, however, that "hypothetical illustrations of mathematical principles are not considered projections of performance" and references "illustrations designed to show the effects of dollar cost

averaging, tax-free compounding, or the mechanics of variable annuity contracts or variable life policies” as examples of the type of illustrations that are not “projections of performance.” The NASD staff, particularly the staff of the NASD’s Advertising Regulation Department, has objected to certain member firms providing customers with access to interactive technological tools that produce simulations and statistical analyses showing a range of probabilities that various investment outcomes might occur, although the interpretive basis for this objection remains open to debate.

Recently, there has been great demand among investors for investment information and tools to aid in the investment decision-making process, including in assessing the probability that certain investments or investment strategies may produce a particular result or range of results. Tools of this kind have been available to institutional investors, but advances in technology have brought them within the reach of retail investors. Variations of these tools are even found on the NASD’s website (in the form of a retirement calculator) and through the hyperlink from the U.S. Securities and Exchange Commission’s website.² Some of these tools, like those available through the NASD and SEC sites, assume a (possibly unrealistic) fixed rate of return, while many more sophisticated tools seek to factor in the probabilities of different rates of return. These tools generally are offered as a starting point for an investor’s research. The tools provide value by enabling investors to evaluate different scenarios by manipulating the data they enter.

To date, these tools have been offered in both institutional and retail channels by a variety of vendors (including registered and unregistered investment advisers, banks, financial planners, Internet web sites and other non-registered persons). Indeed, for several years, NASD member firms have provided their customers with access to third-party investment analysis tools via a hyperlink from their websites or other arrangements, and we are not aware of any significant investor protection issues that have arisen in this connection.

Given the practical experience gained over the last several years, we agree in concept with the NASD’s proposal to permit member firms to provide customers with investment analysis tools and believe that this will serve the interests of investors. Allowing member firms to make these tools available avoids the “regulatory arbitrage” that can result where member firms are barred from providing these useful tools while unregulated entities are not. Moreover, uncertainty about the types of investment analysis tools that may be provided by brokers has discouraged the development of such

² The NASD makes available a retirement calculator in its “Investor Center” http://www.nasdr.com/retirement_calc.asp that calculates the probable amount of savings required to reach an annual income goal in retirement assuming a constant 8% annual yield (or such other yield as the investor may specify). The SEC makes a similar tool available by hyperlink from its “Investor Information” site <http://www.sec.gov/investor/tools.shtml>. This tool applies an embedded, though undisclosed, yield.

tools in the brokerage industry. Accordingly, we support the NASD's steps to provide member firms with greater flexibility in making these useful tools available to investors.

With this support in mind, we would like to address our observations of the Interpretive Material and our recommendations for its refinement.

1. Certain Characterizations of Rule 2210(d)(2)(N) Should be Clarified

SIA is concerned the Interpretive Material mischaracterizes Rule 2210(d)(2)(N) by stating in several places, without qualification, that the rule "prohibits member firms from predicting or projecting investment results in communications to the public." This broad reading seems to conflict with commonly held views of what the prohibition covers, the plain language of Rule 2210 (d)(2)(N), and other applicable NASD and NYSE rules.

First, member firms have always been permitted to provide opinions and forecasts of future events subject to the requirements of Rule 2210(d)(2)(C) that opinions have a "reasonable basis" and forecasts be appropriately identified as such and not be "unwarranted."

Second, NASD rules applicable to options products and NYSE Rule 472 permits predictions, projections, and forecasts that are clearly labeled as such.

Third, Rule 2210(d)(2)(N), as noted above, itself excepts hypothetical illustrations of mathematical principles, including illustrations designed to show the effects of dollar cost averaging, tax-free compounding, or the mechanics of variable annuity contracts or variable life policies.

We, therefore, recommend that the NASD either revise the Interpretive Material to clarify what the existing prohibition applies to, or simply eliminate the problematic references in the discussion to past staff interpretations since they have the effect of upsetting settled expectations of what is permissible.

2. The Definition of "Investment Analysis Tools" Should be Refined

The Interpretive Material would describe "investment analysis tools" to mean "an interactive technological tool that produces simulations and statistical analyses that present a range of probabilities that various investment outcomes might occur thereby enabling investors to evaluate the potential risks of and returns on particular investments." We believe the definition ought to appropriately encompass the range of investment analysis tools that are in use today and may be developed tomorrow. SIA recommends including additional information about general characteristics or properties

of a tool in the rule or discussion language to make the definition sufficiently inclusive and, at the same time, to remind members of their obligations with respect to certain tools. The language should be inclusive in the sense that tools that rely on mathematical principles and statistical probability are eligible under the definition. To the degree that such tools include forecasts, they must be fair, balanced, and not misleading. Forecasting tools that display bias, subjectivity, or skew recommendations toward specific recommendations, must not only be fair, balanced and not misleading, but may also be subject to suitability rules. The additional language would promote consistency with the NASD's position on forecasts and recommendations since tools that produce forecasts (i.e., those showing potential returns) would seem to be permitted under section 2210(d)(2)(C) as long as they have a reasonable (i.e., statistical or mathematical) basis and the result is warranted (i.e., not subject to external manipulation or bias), while tools that produce a call to action on the part of the investor are currently subject to suitability rules.

In addition to expanding on the characteristics and properties of the tools in the definition or discussion, the SIA is also recommending that the NASD clarify the application of the rule based on how the customer accesses the tool. The proposed definition includes the word "interactive", but does not explain what that term means. The discussion seems to provide some helpful insight into the NASD's intentions in the section that contrasts the staff's approach to customer direct access to tools with public access to tools via financial advisors and institutions. Although we have structured our recommended safe harbor approach to cover legitimate tools, regardless of how or by whom they are accessed, the NASD should consider using clearer language to indicate that tools offered by investment advisers and brokers (or otherwise not offered directly to customers) and tools offered to institutions are exempt from the rule.

3. The Interpretive Material Should be Set Forth as a Non-Exclusive Safe Harbor

We believe that the Interpretive Material should be presented as a non-exclusive safe harbor that generally allows the use of investment tools as defined above with appropriate disclosures. Taking a safe harbor approach that is grounded in Rule 2210's general purpose – to ensure that communications with the public are fair, balanced, and not misleading – furthers the purpose of the Rule and allows flexibility to encourage innovation. This kind of an approach also recognizes the variety of tools in this area and allows member firms to tailor their approach to different types of tools and clients, including "institutional accounts" as defined by NASD Rule 3110(c)(4) which have greater sophistication and an independent ability to assess and use these tools. This approach would achieve the objective of ensuring that the Interpretive Material is technologically neutral and does not force member firms to take the same approach with retail-oriented tools (such as those offered by Risk Metrics, Financial Engines, Inc. and mPower.com, Inc.) as they would more institutional-oriented investment analysis tools. Accordingly, we recommend that the Interpretive Material make clear that no presumption will arise that a member firm has violated Rule 2210(d)(2)(N) solely by

reason of it offering an investment analysis tool without satisfying the specific disclosure requirements of paragraph (c) of the Interpretive Material, so long as the member firm provides investors with such information as the member firm reasonably believes would be appropriate for a fair and balanced presentation of information to an investor using such a tool.

4. NASD Should Revise the Disclosure Requirements for Investment Analysis Tools to Limit Any Required Disclosures to Information that Would be Appropriate for a Fair and Balanced Presentation of Information to an Investor Using the Investment Analysis Tool

Consistent with the safe harbor approach recommended above, we believe that the best approach to disclosure requirements for investment analysis tools would be a flexible one that is designed to ensure that the offering of investment analysis tools conforms to Rule 2210's general purpose – to ensure that communications with the public are fair, balanced, and not misleading. To this end, we do not believe that a “one size fits all” approach is appropriate or workable. Instead, we recommend that the NASD adopt an approach that requires member firms that provide investment analysis tools and use related sales material to do so only where they provide appropriate information they reasonably believe would be material to an investor's use of the investment analysis tool. This approach would recognize that appropriate disclosures may vary depending on the circumstances, including the nature of the particular investment analysis tool and the sophistication of the investors using the tool. Although we do not believe that member firms should necessarily be required to disclose each and every bit of information identified in the proposed Interpretive Material where circumstances do not warrant it, we would recommend, subject to our comments below, that such points of information be provided as illustrations of the sort of information that may, depending on the circumstances, be appropriate for a balanced presentation on the use of an investment analysis tool.

5. The Specific Disclosure Requirements for Investment Analysis Tools Should be Revised As Follows

Below we offer our specific thoughts concerning the individual disclosure requirements proposed under paragraph (c) of the Interpretive Material:

- **Disclosure Item (c)(2) – Range of Possible Investment Outcomes**

Proposed item (c)(2) would require a member firm providing an investment analysis tool to “prominently disclose the range of all possible investment outcomes generated by the investment analysis tool.” This requirement is paraphrased somewhat differently in the accompanying commentary as requiring a firm to disclose “the entire range of possible outcomes, giving both the downside risk and upside gain.” SIA believes that prominently disclosing “all” possible investment outcomes could swamp the

investor with information and cause unnecessary confusion. If the goal is to provide the investor with some appropriate level of context by which to evaluate a likely outcome or range of outcomes, then the rule ought merely require a “fair presentation of the range of possible outcomes.”

It should also be noted that the tool may limit investment outcomes by virtue of the output desired by the customer or the parameters input by the customer. For example, some tools are designed to show the likelihood of attaining a certain investing goal based on a customer’s current portfolio. It is not clear in this example what additional information customers should have. SIA believes that the general requirement that information presented be fair, balanced, and not misleading, ought to suffice to address the NASD’s concern. If the NASD believes it is necessary to include language that specifically relates to investment outcomes, SIA recommends allowing firms sufficient flexibility to present a “fair presentation” of possible outcomes according to the specific facts and circumstances involved.

- **Disclosure Item (c)(3) – Use a Reproducible Mathematical Process**

Proposed item (c)(3) would require that an investment analysis tool “use a reproducible mathematical process.” We do not know what a reproducible mathematical process would entail. We would have substantial concerns were this requirement construed to require that a member firm be able to reproduce each and every analysis or computation performed – a feat that while theoretically possible is practically impossible. We would similarly be concerned were this requirement construed to limit a member firm’s ability to modify a tool’s processes. We believe this requirement is unnecessary, particularly given a member firm’s general responsibility for the investment analysis tools it offers, and should be eliminated.

- **Disclosure Item (c)(4) – Criteria and Methodology**

Proposed item (c)(4) would require a description of the criteria and methodology used. Footnote 2 to the Interpretive Material states that the description “should provide detailed information about how the tool conducts its analyses and the principles on which those analyses are based, including, but not limited to, the security-or fund-specific attributes of the recommended securities or mutual funds, transaction costs, tax implications, interest rate and inflationary analysis, historical performance, and the consistency of that performance over time.” We agree that information concerning the criteria and methodology used can be important information to investors when considering the use of an investment analysis tool but believe any requirements of disclosure in this area should be limited to those matters that would be, in the member firm’s reasonable judgment, appropriate to presenting a fair and accurate presentation to an investor using such a tool. In this regard, information about each of the matters described in the footnote may not warrant “detailed” description. As with the general

categories of information set forth under paragraph (c), we believe that the footnote does provide useful illustrations of the sorts of information that may, depending on the circumstances, be appropriate for disclosure where they are necessary to provide a fair and balanced presentation of information to an investor using an investment analysis tool.

- **Disclosure Item (c)(6) – Universe of Investments Considered**

Proposed Item (c)(6) would require a member firm to disclose the “universe of investments considered in the analysis” and state that “other investments not considered may have characteristics similar to those being analyzed.” Disclosure of the complete universe of investments that may be considered by an investment analysis tool could potentially be unwieldy unless firms are able to provide this information by category of investments. For example, a member firm may want to confine any investment recommendations to those investments that it is qualified or otherwise situated to offer. In addition, we would ask that the NASD clarify that the universe of investments “considered in the analysis” refers to those investments that may be recommended through the tool rather than those that may be “considered” within the tool’s computations or analysis. Finally, as to the requirement that a member firm state that other investments not considered may have characteristics similar to those being analyzed, we believe in most cases that concept would be inferred from a member firm’s description of the universe of investments considered and, in any event, should be required to be included only in those situations where a member firm reasonably believes it is necessary to provide the investor with a fair and balanced presentation of information. We note in this regard that the provisions of NASD Rule 2210(2)(B), with regard to recommendations generally, do not similarly require that a member firm disclose in the context of each recommendation that other securities not considered or recommended may be appropriate. We see no reason to take a different approach in the case of investment analysis tools.

- **Disclosure Item (c)(8) – All Material Assumptions**

Proposed Item (c)(8) would require that a member firm offering an investment analysis tool “explain all material assumptions in a clear and understandable manner.” Footnote 4 of NTM 02-51 goes on to state “the tool should also explain fully the differences between the securities or mutual funds previously owned and the securities or mutual funds recommended so that the customer can assess the tool’s analysis. If the tool recommends a mutual fund, the tool should provide information about the fund’s investment objectives, fees and expenses and other pertinent information, and the fact that these attributes can change.”

We agree that investors should be provided with information sufficient to enable them to evaluate an investment analysis tool. However, we believe that exhaustive explanations of the differences between investments previously owned and those recommended may be impractical and, in any event, is not consistent with the notion that

these tools are offered (just as the tool on the NASD's website) as a starting point for an investor's research. Firms have little knowledge of or control over the information submitted by a customer. It is this information that weighs most significantly in the determining the ultimate information output by the tool. For example, a member firm may not have complete information, or indeed any information, about the investment previously owned by a customer. This may arise with municipal securities and mutual funds, which abound in numbers beyond the capability of many firms to gather current information. Accordingly, we recommend that this portion of footnote 4 be deleted. Similarly, where a tool identifies a mutual fund as a possible investment alternative, it should suffice that the tool present information on how an investor can obtain a prospectus or other information with regard to the fund rather than have to set forth detailed information concerning the fund.

We agree, however, with the Item's approach of requiring disclosure only of "material assumptions" – which we understand to mean those assumptions that, in a member firm's reasonable belief, would be appropriate for a fair and balanced presentation of information to a user of an investment analysis tool. At the same time, it is important to balance the detail of any disclosures in this area with what investors can reasonably understand. Moreover, we note that research reports are not required to state all material assumptions, even though research reports may include predictions or projections as we discussed above.

6. NASD Should Eliminate the Requirement to Include Disclosures in Sales Material Related to Investment Analysis Tools

Paragraph (c) of the Interpretive Material would require member firms to include required disclosures and information not only within the tools themselves but also in any related sales material. The term "related sales material" is not defined, but presumably refers to advertisements and sales literature as defined by Rule 2210. We believe that a member firm should not be required to incorporate within tool-related sales material any disclosures or other information that may otherwise be required to be disclosed to an investor using an investment analysis tool except where needed to balance claims made in the sales material. So long as investors are provided with the appropriate disclosure to enable them to evaluate an investment analysis tool, it should not matter that such information is included in related sales material. This is especially so if the related sales material includes only an incidental or passing reference to an investment analysis tool.

7. NASD Should Eliminate the Requirement that a Member Firm Using an Investment Analysis Tool File that Tool with the NASD

As proposed, the Interpretive Material would require a member firm that intends to offer an investment analysis tool to provide the NASD's Advertising Regulation Department with access to the investment analysis tool at least 30 days prior to first use, together with any sales material concerning the tool. In addition, footnote 4 of NTM 02-

51 states that “members should file with the NASD’s Advertising Regulation Department any Web pages that include hyperlinks to Websites that contain investment analysis tools to determine the extent to which the member firm is responsible for the content and filing of such sites.” We believe that investment analysis tools and related sales materials should not be subject to pre-filing requirements with the NASD. Such tools are neither advertisements nor sales literature and we object to their inclusion as such. As we have discussed above, NASD rules permit member firms to provide forecasts and projections in research reports, as well as to offer projections that provide hypothetical illustrations of mathematical principles, without any filing with the NASD. Again, we see no reason to take a different approach in the case of investment analysis tools. Such a requirement would also tax the resources of the NASD staff and would likely lead to significant delay in making such tools available to investors. This delay would put broker-dealer firms at a significant competitive disadvantage to unregulated entities offering such tools.

Moreover, most sophisticated modeling tools are protected by trade secret or patent protection, and may be subject to confidentiality agreements. Such agreements can arguably conflict with the disclosure expected by the NASD.

8. The NASD Should Clarify its Statements about the Extent of a Member Firm’s Responsibility for Investment Analysis Tools

We are concerned about the open-ended nature of this characterization of a member firm’s responsibility for the “use of the investment analysis tool and all recommendations,” particularly given the varied circumstances involved. A member firm is not in a position to control an investor’s use of an investment analysis tool (including the values an investor may enter). Moreover, any recommendations are based solely on the information entered by a user. As discussed above, the value of these tools to many investors is that these tools enable investors to evaluate different scenarios by manipulating the data they enter. Because of this, it is seldom clear whether an investor is providing information on himself or herself – or some other relative or friend – or whether any information an investor may enter is actual or hypothetical. In addition, investors generally use these tools as a starting point in their investment decision-making. Accordingly, while we agree that a member firm’s offering of investment analysis tools may carry suitability obligations in a general sense, we caution that the NASD should not leap to the judgment that such tools necessarily trigger customer-specific suitability obligations. To borrow from the NASD’s Notice to Members 01-23 (Online Suitability), “the determination of whether a portfolio analysis tool’s communication constitutes a ‘recommendation’ will depend on the content, context, and presentation or series of communications.”³ Finally, consistent with the notion that the results or output of an investment analysis tool represents a forecast of possible outcomes, we believe the NASD should clarify that a member firm providing access to an investment analysis tool

³ See NASD Notice to Members 01-23 (April 2001) at n. 15; see also Commissioner Laura Unger, SEC, On-Line Brokerage: Keeping Apace of Cyberspace, 34 (November 1999) <<http://www.sec.gov/pdf/cybrtnd.pdf>>.

is not a guarantor of such results. Rather, we believe the NASD should clarify that the standard for its possible responsibility in this context is the same "reasonable basis" standard that applies generally in connection with recommendations under Rule 2210.

9. NASD Should Provide a Form of Disclosure but Still Permit Member Firms to Use Alternative Disclosures

Finally, in concept we agree with the NASD's approach in paragraph (d)(2) of providing a form of disclosure for member firms to use, particularly if the requirements of the Interpretive Material are set forth as a safe harbor, as we recommend. Nonetheless, consistent with the NASD's approach to margin disclosure statements under Rule 2341(c), members should be able to develop and use alternative disclosure so long as the disclosures are similar to the standard form of disclosure stated in the Interpretive Material.

As to the specific form of disclosure proposed in the Interpretive Material, we recommend that NASD simplify the disclosure to make it clearer and more direct. One possibility would be "Projections and forecasts are hypothetical and depend on the variables you insert. There are no guarantees that future results will be the same as those displayed."

Conclusion

The Committees appreciate this opportunity to comment on the proposed amendments to Rule 2210(d)(2)(N). If you have any questions about any of the positions taken in this letter, you may contact Scott C. Kursman, Associate General Counsel, at (212) 618-0508.

Very truly yours,

Mike Hogan
Chair, Online Brokerage
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