

Notice to Members

NOVEMBER 2004

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Senior Management

KEY TOPICS

IM-2210-6
Investment Analysis Tools
Predictions or Projections

GUIDANCE

Investment Analysis Tools

SEC approves NASD Interpretive Material to Rule 2210 regarding member firms' use of investment analysis tools; **Effective Date: February 14, 2005**

Executive Summary

On September 28, 2004, the Securities and Exchange Commission (SEC) approved an NASD Interpretive Material (IM) to Rule 2210, designated as IM-2210-6, regarding "investment analysis tools."¹ IM-2210-6 will allow members to use and provide customers access to investment analysis tools if the members comply with certain disclosure and other requirements. The new rule text is contained in Attachment A and is effective on **February 14, 2005**.

Questions/Further Information

Questions regarding this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Advertising Regulation Department (Advertising Department), Regulatory Policy and Oversight (RPO), at (240) 386-4533; Thomas A. Pappas, Associate Vice President, Advertising Department, RPO, at (240) 386-4553; or James S. Wrona, Associate General Counsel, Office of General Counsel, RPO, at (202) 728-8270.

Background

In recent years, the public increasingly has sought access to additional sources of investment information and tools to make investment decisions. Technology has been a key component of members' attempts to meet this investor demand. NASD Rule 2210(d)(1)(D), however, prohibits members from making predictions or projections regarding investments or investment strategies.² This

prohibition, in turn, precluded member firms from offering investors technological tools that used a mathematical formula to calculate the probability that investment outcomes (such as reaching a financial goal) would occur. As part of its rule modernization project, NASD proposed IM-2210-6 as a limited exception to the general prohibition on predictions and projections in Rule 2210(d)(1)(D) to allow members to offer such technological tools under certain circumstances.³ On September 28, 2004, the SEC approved the proposal.⁴ IM-2210-6 becomes effective on **February 14, 2005**.

With this change, members that comply with the disclosure and other requirements of IM-2210-6 will be permitted to offer customers the use of investment analysis tools.⁵ IM-2210-6 defines an investment analysis tool as “an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices.” Members also will be permitted to provide customers with written reports generated by and sales material concerning investment analysis tools.

Pursuant to IM-2210-6, a member may offer an investment analysis tool (whether customers use the member’s investment analysis tool independently or with assistance from the member), written reports indicating the results generated by such tool and related sales material only if the member:

- ▶ Describes the criteria and methodology used, including the investment analysis tool’s limitations and key assumptions.
- ▶ Explains that results may vary with each use and over time.
- ▶ Describes, if applicable, the universe of investments considered in the analysis; explains how the tool determines which securities to select; discloses if the tool favors certain securities and, if so, explains the reason for the selectivity; and states that other investments not considered may have characteristics similar or superior to those being analyzed.
- ▶ Displays the following additional disclosure: “IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.”

These disclosures must be clear and prominent and must be in written (electronic or hard copy) narrative form.⁶ In addition, a member that offers or intends to offer an investment analysis tool, written report, or related sales material under IM-2210-6 must, *within 10 days of first use*, (1) provide the Advertising Department access to the investment analysis tool and (2) file with the Advertising Department any template for written reports produced by, and sales material concerning, the tool.⁷ Moreover, after the Advertising Department has reviewed the investment analysis tool, written-report template or sales material, a member must notify the Advertising Department and provide additional access to the tool and re-file any template and sales material if the member makes a *material change* to the presentation of information or disclosures.

If a member is already using an investment analysis tool that falls within the rule's coverage, and the member has not previously filed this tool with the Advertising Department, the member must file the tool, any written-report template generated by the tool, and sales material for the tool within 10 days of the effectiveness of IM-2210-6. In addition, even if a member previously filed an investment analysis tool with the Advertising Department, the member must re-file the tool, written-report template and sales material within 10 days of the effectiveness of IM-2210-6, so that the Advertising Department can ensure that the member has met the rule's requirements.

The filing requirement does not apply to hypothetical illustrations of mathematical principles that do not predict or project the performance of an investment or investment strategy, such as Web site calculators that compute future returns based upon assumed variables, since Rule 2210(d)(1)(D) does not prohibit (and IM-2210-6 thus does not cover) such illustrations.⁸ In addition, a member that offers an investment analysis tool exclusively to "institutional investors," as defined in Rule 2211(a)(3), is not subject to the filing requirements discussed above if the communications relating to or produced by the tool meet the criteria for "institutional sales material," as defined in Rule 2211(a)(2).⁹ Furthermore, sales material that contains only an incidental reference to an investment analysis tool (e.g., a brochure that merely mentions a member's tool as one of the services offered by the member) need not include the disclosures required by IM-2210-6 and would not need to be filed with the Advertising Department, unless otherwise required by the other provisions of Rule 2210. However, any description of the tool or its features will trigger application of the disclosure and filing requirements of IM-2210-6.

Members must keep in mind that compliance with IM-2210-6 does not mean that the member is acting in conformity with other applicable laws and rules. A member that offers an investment analysis tool under IM-2210-6 (whether customers use the member's investment analysis tool independently or with assistance from the member) is responsible for ensuring that use of the tool and all recommendations based on the tool (whether made via the automated tool or a written report) comply with the federal securities laws, NASD rules and SEC rules, including, but not limited to, as applicable, the following:

- ◆ NASD's suitability rule (Rule 2310).
- ◆ The other provisions of Rule 2210 (including the principles of fair dealing and good faith; the prohibition on exaggerated, unwarranted or misleading statements or claims; and any other applicable filing requirements for advertisements and sales literature).
- ◆ SEC rules (including SEC Rule 156 under the Securities Act of 1933).

Endnotes

1. See SEC Order Approving NASD New Interpretive Material to Rule 2210 Regarding Investment Analysis Tools (SEC Order Regarding Investment Analysis Tools), Exchange Act Rel. No. 50463 (Sept. 28, 2004), 69 FR 60200 (Oct. 7, 2004) (SR-NASD-2003-13).
2. Rule 2210(d)(1)(D) states:

Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or project the performance of an investment or investment strategy.
3. Rule 2210(d)(1)(D), by its explicit language, does not prohibit (and IM-2210-6 thus does not cover) certain hypothetical illustrations of mathematical principles that do not predict or project the performance of an investment or investment strategy. The "hypothetical illustration" exception to the prohibition in Rule 2210(d)(1)(D) applies to tools that serve the function of a calculator that computes the mathematical outcome of certain assumed variables without predicting the likelihood of either the assumed variables or the outcome. For example, this exception would apply to a calculator that computes a net amount of savings that an investor would earn over an assumed period of time with assumed variables of rates of returns, frequency of compounding, and tax rates. On the other hand, this exception would not apply to a calculator that predicted the likelihood of achieving these assumed variables and outcomes.
4. During the rulemaking process, NASD modified the original proposal to accommodate a number of commenters' concerns submitted in response to the public comment notification in the *Federal Register*. See SEC Order Regarding Investment Analysis Tools, Exchange Act Rel. No. 50463, 69 FR 60200, at 60203-60204 (discussing NASD's response to comments and modifications to original proposal).
5. For guidance on whether a member must comply with IM-2210-6 regarding a hyperlink to an affiliated or unaffiliated Web site that offers an investment analysis tool, see NASD *Interpretive Letter, Response to Recommendations of the Investment Company Institute Concerning Hyperlinks* (Nov. 11, 1997) (discussing members' responsibilities for content and filing requirements for ongoing hyperlinks to Web sites created by independent parties). If a member is responsible for the information on the hyperlinked Web site under the analyses discussed in the November 1997 Interpretive Letter, the member must either comply with IM-2210-6 or discontinue the hyperlink.
6. Although each required disclosure need not be displayed on every separate Web page and/or page of a written report generated by the tool, the disclosures must be "clear and prominent" in light of the content, context, and presentation of the tool and/or written report. In addition, if the member provides customers access to an investment analysis tool and written report generated by the tool, the disclosures must be clear and prominent on both the tool and the written report. A member may not provide clear and prominent disclosures on one but not the other. For instance, a member cannot simply refer in a written report to the disclosures made by the tool (and vice versa).

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7. The Advertising Department's review of investment analysis tools generally will focus on whether the member has made the proper disclosures. Members are cautioned that they may not imply that NASD endorses or approves the use of any investment analysis tool or any recommendation based on such a tool.
 8. See *supra* note 3 and accompanying discussion.
 9. If a member presents an investment analysis tool on its Web site and non-institutional customers can access and use the tool, the member must comply with the filing requirements. This would be true even if the member indicated on its Web site that only institutional customers should use the tool. Moreover, members should note that, even if the investment analysis tool were offered exclusively to institutional customers, the member still would have to adhere to the disclosure requirements and would retain suitability obligations to the extent they arise in connection with the use of the investment analysis tool by such institutional customers.

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ATTACHMENT A

Text of Rule Change

New language is underlined.

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IM-2210-6. Requirements for the Use of Investment Analysis Tools

(a) General Considerations

This Interpretive Material provides a limited exception to NASD Rule 2210(d)(1)(D).¹ No member may imply that NASD endorses or approves the use of any investment analysis tool or any recommendation based on such a tool. A member that offers or intends to offer an investment analysis tool under this Interpretive Material (whether customers use the member's tool independently or with assistance from the member) must, within 10 days of first use, (1) provide NASD's Advertising Regulation Department (Department) access to the investment analysis tool and (2) file with the Department any template for written reports produced by, or sales material concerning, the tool.² The member also must provide any supplemental information requested by the Department. The Department may require that the member modify the investment analysis tool, written-report template or sales material. The Department also may require that the member not offer or continue to offer or use the tool, written-report template or sales material until all changes specified by the Department have been made by the member.

A member that offers an investment analysis tool exclusively to "institutional investors," as defined in Rule 2211(a)(3), is not subject to the post-use access and filing requirement in this paragraph if the communications relating to or produced by the tool meet the criteria for "institutional sales material," as defined in Rule 2211(a)(2). A member that intends to make the tool available to, or that intends to use the tool with, any person other than an institutional investor (such as an employee benefit plan participant or a retail broker-dealer customer) will be subject to the filing and access requirements, however.

1 NASD Rule 2210(d)(1)(D) states that "[c]ommunications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." This Interpretive Material allows member firms to offer investment analysis tools (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tools and related sales material in certain circumstances.

Rule 2210(d)(1)(D) does not prohibit, and this Interpretive Material does not apply to, hypothetical illustrations of mathematical principles that do not predict or project the performance of an investment or investment strategy.

2 After the Department has reviewed the investment analysis tool, written-report template or sales material, a member must notify the Department and provide additional access to the tool and re-file any template or sales material if it makes a material change to the presentation of information or disclosures as required by paragraphs (c) and (d).

As in all cases, a member's compliance with this Interpretive Material does not mean that the member is acting in conformity with other applicable laws and rules. A member that offers an investment analysis tool under this Interpretive Material (whether customers use the member's tool independently or with assistance from the member) is responsible for ensuring that use of the investment analysis tool and all recommendations based on the investment analysis tool (whether made via the automated tool or a written report) comply, as applicable, with NASD's suitability rule (Rule 2310), the other provisions of Rule 2210 (including, but not limited to, the principles of fair dealing and good faith, the prohibition on exaggerated, unwarranted or misleading statements or claims, and any other applicable filing requirements for advertisements and sales literature), the federal securities laws (including, but not limited to, the antifraud provisions), the Securities and Exchange Commission rules (including, but not limited to, SEC Rule 156 under the Securities Act of 1933) and other NASD rules.

(b) Definition

For purposes of this Interpretive Material and any interpretation thereof, an "investment analysis tool" is an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices.

(c) Use of Investment Analysis Tools and Related Written Reports and Sales Material

A member may provide an investment analysis tool (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tool and related sales material³ only if:

- (1) the member describes the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;
- (2) the member explains that results may vary with each use and over time;
- (3) if applicable, the member describes the universe of investments considered in the analysis, explains how the tool determines which securities to select, discloses if the tool favors certain securities and, if so, explains the reason for the selectivity⁴; and states that other investments not considered may have characteristics similar or superior to those being analyzed; and

³ Sales material that contains only an incidental reference to an investment analysis tool (e.g., a brochure that merely mentions a member's tool as one of the services offered by the member) need not include the disclosures required by this Interpretive Material and would not need to be filed with the Department, unless otherwise required by the other provisions of Rule 2210.

(4) the member displays the following additional disclosure: “IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.”

(d) Disclosures

The disclosures and other required information discussed in paragraph (c) must be clear and prominent and must be in written or electronic narrative form.

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- 4 This disclosure must indicate, among other things, whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered based on revenue received by the member in connection with the sale of those securities or based on relationships or understandings between the member and the entity that created the investment analysis tool. The disclosure also must indicate whether the investment analysis tool is limited to searching, analyzing or in any way favoring securities in which the member makes a market or has any other direct or indirect interest. Members are not required to provide a “negative” disclosure (i.e., a disclosure indicating that the tool does *not* favor certain securities).