Notice to Members

APRIL 2004

SUGGESTED ROUTING

Advertising/Investment Companies
Debt Securities
Executive Representatives
Legal & Compliance
Mutual Funds
Registered Representatives
Senior Management
Training

KEY TOPICS

Debt Securities
Municipal Securities
Mutual Funds
Sales Practice Obligations

GUIDANCE

Sales Practice Obligations

NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds

Executive Summary

As the number of retail customers investing in bonds and bond funds grows, NASD is concerned that many investors may not fully appreciate the risks and costs associated with such products.[1] It is the responsibility of firms to take appropriate steps to ensure that their registered representatives understand and inform their customers about the risks as well as the rewards of the products they offer and recommend. The purpose of this *Notice* is to remind firms that sell bonds and bond funds of their sales practice obligations in connection with such products.

Questions/Further Information

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Discussion

The number of individual investors purchasing bonds or bond funds has increased dramatically in recent years. Bonds and bond funds may be viewed—and in some cases, marketed—as low-risk, or sometimes even as risk-free alternatives to equity securities. Purchasers of bonds and bond funds often believe that their principal is safe, they are guaranteed a particular yield on their investment, and bonds are inexpensive to purchase because they do not pay a commission or other acquisition cost on the transaction.

While bonds and bond funds can play an important role in stabilizing diversified portfolios, neither product is entirely risk-free. Moreover, their terms, conditions, risks, and rewards vary widely, and in some cases, such as high-yield bonds, the risks may be substantial. NASD is concerned that some investors may not understand the risks and costs associated with bonds and bond funds. For example, a recent study by NASD indicates that 60 percent of investors do not understand that, as interest rates rise, existing bond prices fall, and that long-term bonds are more exposed to interest rate risk than short-term bonds (*see* "NASD Investor Literacy Research" at *www.nasd.com/Investor/pdf-text/surveyexecsum.pdf*). Therefore, when interest rates rise, investors who decide to sell their bond fund may not receive their full investment. In the same environment, investors who decide to sell bonds prior to a call or the maturity date also may not receive the full amount of their principal invested. Because interest rate risk is universal, it is in some ways more problematic for investors than the risk of default, at least with respect to investment grade bonds.

It is the responsibility of firms to take appropriate steps to ensure that their associated persons understand and inform their customers about the risks as well as the rewards of the products they recommend and offer. Given that interest rates are likely to rise from their current and historically low rate, NASD believes that it is imperative that investors understand the various risks, as well as the rewards, associated with debt securities. The purpose of this *Notice*, therefore, is to remind firms of their sales practice obligations in connection with bonds and bond funds. The obligations include:

- Understanding the terms, conditions, risks, and rewards of bonds and bond funds they sell (performing a reasonable-basis suitability analysis);
- Making certain that a particular bond or bond fund is appropriate for a particular customer before recommending it to that customer (performing a customer-specific suitability analysis);[2]
- Providing a balanced disclosure of the risks, costs, and rewards associated with a particular bond or bond fund, especially when selling to retail investors;

- Adequately training and supervising employees who sell bonds and bond funds; and
- Implementing adequate supervisory controls to reasonably ensure compliance with NASD and SEC sales practice rules in connection with bonds and bond funds.

The first step in meeting a firm's sales practice obligations with respect to a bond or bond fund is to ensure that the product being offered is reasonably suitable for investment in general. To make this determination, firms must carefully review and understand the terms and conditions of the product being offered. With individual bonds, for example, the firm must understand the type, term, and yield of the bond; when and if periodic interest payments will be made; if applicable, the conditions under which the issuer may call the bond or the holder may redeem the bond; the credit-worthiness of the issuer; the collateral securing the bond, if any; the costs of the transaction; and any other important features as described in the prospectus. For bond funds, it means, among other things, understanding what type of bonds the fund will purchase; the general terms, conditions, and risks of such bonds; and the costs and fees associated with purchasing and selling shares in the fund. And, in both cases, firms should also understand the tax consequences of the product.

Secondly, firms must ensure that the bonds and bond funds they recommend are suitable for the customer to whom they recommend them. To ensure that a particular investment is suitable for a specific customer, firms and their registered persons must examine a variety of factors, including the customer's financial status, the customer's tax status, the customer's investment objectives, and any other information that the firm uses or considers reasonable to use in making recommendations to that customer.[3] NASD cautions firms against relying too heavily upon a customer's financial status as the basis for recommending particularly risky bonds or bond funds. A customer's net worth alone is not necessarily determinative of whether a particular product is suitable for that investor. Certain high-yield, high-risk products may be suitable for recommending to only a very narrow band of investors capable of evaluating and being financially able to bear those risks.

Thirdly, firms offering bonds and bond funds should take care to present a fair and balanced picture of the risks, costs, and benefits of investing in these products. For example, in the case of individual bonds, customers should be advised as to the credit risk, or risk of default, associated with a particular issuer, and how that risk might affect the safety of the invested principal. Customers should also be advised as to the interest rate risk, or the risk that changes in interest rates during the term of the bond might affect the market value of the bond prior to the call or maturity date. And customers should understand that these investments engender inflation risk; this is the risk that the rate of the yield to call or maturity of the investment will not provide a positive return over the rate of inflation for the period of the investment. For example, if the rate of inflation for the period of an investment is 6 percent and the yield to maturity of a fixed income investment is 4 percent, then, although more dollars are returned to the investor in interest and principal than were invested, the value of those aggregate dollars returned is actually less than the amount originally invested. While this can be true of any investment, investors may believe that the interest rate paid on a bond or bond fund may guard against this effect in a manner superior to an investment in equity securities, which is not necessarily the case. Finally, customers should understand that when a firm buys or sells a bond, the customer is charged for the service, in the form of either a commission, or a mark-up or mark-down.[4]

In the case of bond funds, customers should be aware that return of principal is not guaranteed because of the fluctuation in the net asset value of the fund that is occasioned by changes in the price of specific bonds held in the fund and the buying and selling of bonds within the fund by its investment adviser. In addition, investors should understand that, as with direct bond ownership, bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds owned by the fund. Bond fund purchasers should also understand that, in contrast to owning individual bonds, there are ongoing fees and expenses associated with owning shares of bonds funds.

Firms offering bonds and bond funds should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. However, NASD reminds firms that simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer.[5]

Firms should also take steps to provide appropriate training to, and supervision of, employees who sell bonds and bond funds about the characteristics, risks, and rewards of each product before they allow employees to sell that product to investors. Firms should also train employees who sell such products about the factors that would make such products either suitable or unsuitable for certain investors. In so doing, the firm's focus should not be limited only to registered representatives selling such bonds and bond funds, but should also include supervisors of registered persons selling such products.

And finally, firms should make sure that they implement adequate supervisory controls to ensure that sales of bonds and bond funds comply with all applicable NASD, MSRB, and SEC rules. Among other things, firms must ensure that their written procedures for supervisory and compliance personnel require that the appropriate reasonable-basis suitability is completed before products are offered for sale; associated persons perform appropriate customer-specific suitability analysis and such information is updated periodically; all promotional materials are accurate and balanced; and all applicable NASD, MSRB, and SEC rules are followed. In addition to establishing written procedures, firms also must document the steps they have taken to ensure adherence to these procedures.

Conclusion

There may be a widespread perception among many individual investors that bonds and bond funds are low risk, if not entirely risk-free, investments. In fact, all such products entail some risk, and in some cases, the risk may be substantial. As part of their sales practice obligations, it is the responsibility of firms to take appropriate steps to ensure that they understand and inform their customers about the risks as well as the rewards of all products that they recommend and offer, including bonds and bond funds.

Endnotes

1 Throughout this *Notice*, the term "bond" is used to mean all types of debt securities.

2 For a fuller discussion of the distinctions between "reasonable basis" and "customer specific" suitability analyses, see *NASD Notice to Members 01-23*, Online Suitability (April 2001), Endnote 4.

3 *See* NASD Conduct Rule 2310(b). For municipal securities, see Municipal Securities Rulemaking Board (MSRB) Rule G-19 ("Suitability of Recommendations and Transactions; Discretionary Accounts").

4 Nothing in this *Notice* is meant to broaden a member firm's obligation, under current law and rules, to disclose the amount of remuneration through mark-ups, mark-downs, or commissions. However, members do have an obligation to their customers to disclose that they do in fact receive compensation for such transactions.

5 *See* NASD Letter of Acceptance, Waiver and Consent, *Altegris Invs., Inc., and Robert Amedeo,* No. CAF030015 (April 15, 2003).