Notice to Members

AUGUST 2002

REQUEST FOR COMMENT    ACTION REQUESTED BY SEPTEMBER 13, 2002

Investment Analysis Tools

NASDAQ Requests Comment on Proposed Interpretative Material Regarding Investment Analysis Tools.

Comment Period Expires on September 13, 2002.

Executive Summary

NASDAQ Rule 2210(d)(2)(N) prohibits NASD member firms from making predictions or projections of investment results to the public. NASD staff has interpreted the rule to prohibit members from 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. The proposed Interpretive Material to Rule 2210 (Attachment A) would provide a limited exception to Rule 2210(d)(2)(N), allowing members to provide customers direct access to such tools under certain circumstances. NASD seeks comment on whether it should amend Rule 2210(d)(2)(N) to create such an exception and, if so, on the specific provisions of the proposed Interpretive Material.

Action Requested

NASDAQ requests comment from all interested parties on whether and to what extent NASD should amend Rule 2210(d)(2)(N) to allow members to provide investment analysis tools directly to their customers. Comments must be received by September 13, 2002. Members and interested persons can submit their comments using the following methods:

- mailing Attachment B—Request for Comment Form—along with written comments to NASD
- mailing written comments to NASD
- e-mailing written comments to pubcom@nasd.com
- submitting written comments online on the NASD Web Site (www.nasd.com)
Written comments submitted via hard copy should be mailed to:

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

Important Note: The only comments that will be considered are those submitted in writing or by e-mail.

Before becoming effective, any rule change developed as a result of comments received must be submitted to and approved by the Securities and Exchange Commission (SEC).

Questions/Further Information

Questions or comments concerning the information contained in this Notice to Members (NtM) may be directed to Nancy C. Libin, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8835 or nancy.libin@nasd.com, or James S. Wrona, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8270 or jim.wrona@nasd.com, or Joseph P. Savage, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight, at (240) 386-4534 or joe.savage@nasd.com.

Background

In recent years, the public increasingly has sought access to additional investment information and tools to make investment decisions. Technology has been a key component of members’ attempts to meet this investor demand. NASD’s proposed Interpretive Material to Rule 2210 seeks to modernize certain aspects of the rule to keep pace with investor needs and technological developments. In doing so, however, NASD does not want to compromise Rule 2210’s general purpose—to ensure that “communications [with the public] are fair, balanced, and not misleading.”

NASD Rule 2210(d)(2)(N) prohibits members from predicting or projecting investment results in communications to the public. NASD staff has interpreted this provision to prohibit members from providing their customers with access to automated tools that indicate the probability that an investment strategy will produce a desired result. NASD seeks comment on its proposal to modify that interpretation to allow members to provide customers direct access to such tools under certain, limited circumstances.

The proposed Interpretive Material would allow members to provide customers direct access to such tools under certain, limited circumstances.

Although NASD staff has not permitted members to provide customers direct access to such tools under NASD’s current rules, other financial advisors and institutions have offered public access to similar automated tools for some time. With appropriate disclosures and other safeguards, NASD believes that investors
could properly use these tools in making judgments about how an investment strategy might perform. Importantly, under the proposed Interpretive Material, the tools could not predict that a particular outcome will in fact occur.

NASD is proposing certain requirements for members’ use of the tools with their customers. For instance, among other requirements, members would have to:

- Disclose the entire range of possible outcomes, giving both downside risk and upside gain.
- Disclose the universe of investments considered and state that other investments not considered might have characteristics similar to those that the tools analyze.
- Explain all material assumptions in a clear and understandable manner.
- Disclose whether the tools search, analyze or in any way favor certain securities within the universe of securities considered and explain the reasons for such selectivity.

Members also would need to provide NASD with access to the tools prior to their use and file with NASD any related sales material for its review. The proposed Interpretive Material, moreover, makes clear that, to the extent that these tools make investment recommendations, NASD’s suitability rule, Rule 2310, would apply.⁵

Request For Comment on Proposed Interpretive Material to Rule 2210 Regarding Investment Analysis Tools

NASD is soliciting comments on its proposed Interpretive Material to Rule 2210. NASD requests that members and other interested parties comment on whether Rule 2210(d)(2)(N) should be amended to create an exception that allows members to provide customers direct access to investment analysis tools that indicate probabilities of certain investment outcomes. In addition, NASD seeks comments on the proposed Interpretive Material’s specific provisions. NASD also is interested in receiving comments on the benefits and risks associated with customers’ use of these tools on members’ Web sites.⁶

NASD has found comments from member firms and the public, as well as state and federal regulators, to be a valuable resource in the decision-making process. NASD encourages all interested parties to comment on the concepts discussed above regarding the proposed “investment analysis tools” exception to Rule 2210(d)(2)(N)’s prohibitions. NASD will consider the comments it receives in determining whether to submit the Interpretive Material as a formal rule change to the SEC and, if so, the form that rule change will take. Comments must be submitted by September 13, 2002.
Endnotes

1 NASD Rule 2210(d)(2)(N) states that:

   In communications with the public, investment results cannot be predicted or projected. Investment performance illustrations may not imply that gain or income realized in the past will be repeated in the future. However, for purposes of this Rule, hypothetical illustrations of mathematical principles are not considered projections of performance; e.g., illustrations designed to show the effects of dollar cost averaging, tax-free compounding, or the mechanics of variable annuity contracts or variable life policies.


4 As a general matter, members are responsible for hyperlinked information, including any information contained in a hyperlinked Web site that provides an investment analysis tool. However, under certain limited circumstances, members are not responsible for the content and filing of material that appears on independent, third-party Web sites. See Interpretive Letter from Thomas Selman, Director of NASD Advertising/Investment Companies Regulation, to Craig S. Tyle, General Counsel of Investment Company Institute (Nov. 11, 1997), available at http://www.nasdr.com/2910/2210_01.htm (providing guidance regarding members’ regulatory responsibilities for hyperlinks to third-party Web sites). Because the circumstances surrounding hyperlinks will vary, members should file with NASD’s Advertising Regulation Department any Web pages that include hyperlinks to Web sites that contain investment analysis tools to determine the extent to which the member is responsible for the content and filing of such sites.


6 Will access to these products improve investors’ ability to make investment decisions and properly allocate their assets? Are there any risks that investors will rely too heavily on projected returns without recognizing that their actual returns may be different?

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ATTACHMENT A

Text of Proposed Interpretive Material to Rule 2210

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

(a) General Considerations

This Interpretive Material provides a limited exception to NASD Rule 2210(d)(2)(N). No member may imply that NASD endorses or approves the use of any investment analysis tool or any recommendation based on such a tool. Members that intend to offer an investment analysis tool under this Interpretive Material must provide NASD’s Advertising Regulation Department (Department) with access to the investment analysis tool at least 30 days prior to first use and must file any sales material concerning the tool with the Department at least 30 days prior to use. Members also must provide any supplemental information requested by the Department. If the Department requests changes to the investment analysis tool or sales material, the tool or sales material may not be offered or used until all changes specified by the Department have been made and approved by the Department. In addition, 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. Members that offer an investment analysis tool under this Interpretive Material are responsible for ensuring that use of the investment analysis tool and all recommendations based on the investment analysis tool comply with NASD’s suitability rule, Rule 2310, the other provisions of Rule 2210, and the other applicable federal securities laws and Securities and Exchange Commission and 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 a range of probabilities that various investment outcomes might occur thereby enabling investors to evaluate the potential risks of and returns on particular investments.

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1 NASD Rule 2210(d)(2)(N) prohibits NASD member firms from making predictions or projections of investment results to the public. In the past, the rule also had been interpreted as prohibiting members from providing customers with direct access to investment analysis tools. This Interpretive Material allows member firms to offer such tools in certain circumstances.
(c) Use of Investment Analysis Tools and Related Sales Material

Members may provide investment analysis tools and use related sales material only if they:

1. present a range of probabilities that various investment outcomes might occur and do not state that a particular investment outcome will, in fact, occur;
2. prominently disclose the range of all possible investment outcomes generated by the investment analysis tool;
3. use a reproducible mathematical process;
4. describe the criteria and methodology used;2
5. give investors a fair and balanced presentation of the risks as well as the potential rewards of using the investment analysis tool, including, but not limited to:
   (A) identification and explanation of the limitations of the methodology employed; and
   (B) an explanation that it is likely that the analysis will change over time with respect to the same investments.
6. disclose the universe of investments considered in the analysis and state that other investments not considered may have characteristics similar to those being analyzed;
7. disclose whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered, beyond the criteria and methodology disclosed under paragraph (c)(4), and the reasons for this selectivity;3 and

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2 This disclosure 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.

3 This disclosure should 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 should 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.
(8) explain all material assumptions in a clear and understandable manner.  

(d) Disclosures

(1) The disclosures and other required information discussed in paragraphs (c) and (d)(2) must be in narrative form, may not be contained in footnotes or in a font size that is inconsistent with the tool’s overall written presentation, and, where feasible, should be located in areas related to the subject of the disclosure or other required information; and

(2) members must prominently display the following additional disclosure:

“IMPORTANT: The forecasts or other information generated by [brand name of investment analysis tool] regarding the probabilities that various investment outcomes might occur are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. [Brand name of investment analysis tool] only presents a range of possible outcomes.”

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4 The investment analysis tool should provide the investor with information sufficient to evaluate the tool’s analysis and forecast. The tool also should 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.
ATTACHMENT B

Request for Comments Form

Proposed Interpretive Material to Rule 2210 Regarding Members’ Ability to Provide Customers Direct Access to Investment Analysis Tools

We have provided below a form that members and other interested parties may use in addition to written comments. This form is intended to offer a convenient way to participate in the comment process, but it does not cover all aspects of the proposal described in the Notice to Members (NtM). We therefore encourage members and other interested parties to review the entire NtM and provide written comments, as necessary.

Instructions

Comments must be received by September 13, 2002. Members and interested parties can submit their comments using the following methods:

➧ mailing Attachment B—Request for Comment Form—along with written comments to NASD
➧ mailing written comments to NASD
➧ e-mailing written comments to pubcom@nasd.com
➧ submitting written comments online on the NASD Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500
Proposed Interpretive Material to Rule 2210 Regarding Members’ Ability to Provide Customers Direct Access to Investment Analysis Tools

NASD requests comment from all interested parties on whether and to what extent Rule 2210 should be amended to allow members to provide investment analysis tools directly to their customers. In particular, NASD seeks input on the following topics:

1. Should NASD amend Rule 2210(d)(2)(N) to permit members to provide investment analysis tools directly to their customers?

   ○ Yes  ○ No  ○ See my attached written comments

2. If yes, should members be permitted to provide investment analysis tools directly to their customers and use related sales material only if they present a range of probabilities that various investment outcomes might occur and do not state that a particular investment outcome will, in fact, occur?

   ○ Yes  ○ No  ○ See my attached written comments

3. Should members be permitted to provide investment analysis tools directly to their customers and use related sales material only if they use a reproducible mathematical process?

   ○ Yes  ○ No  ○ See my attached written comments

4. Should firms be required to provide the information listed below?
   a. The range of all possible investment outcomes generated by the investment analysis tool.

      ○ Yes  ○ No  ○ See my attached written comments

   b. The criteria and methodology used.

      ○ Yes  ○ No  ○ See my attached written comments

   c. The risks as well as the potential rewards of using the investment analysis tool, including, but not limited to: identification and explanation of the limitations of the methodology employed; and an explanation that it is likely that the analysis will change over time with respect to the same investments.

      ○ Yes  ○ No  ○ See my attached written comments
d. The universe of investments considered in the analysis and whether other investments not considered may have characteristics similar to those being analyzed.

☐ Yes  ☐ No  ☐ See my attached written comments

e. Whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered and the reasons for this selectivity.

☐ Yes  ☐ No  ☐ See my attached written comments

5. Should members also be required to display the following additional disclosure?

"IMPORTANT: The forecasts or other information generated by [brand name of investment analysis tool] regarding the probabilities that various investment outcomes might occur are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. [Brand name of investment analysis tool] only presents a range of possible outcomes."

☐ Yes  ☐ No  ☐ See my attached written comments

6. Will access to these products improve investors’ ability to make investment decisions and properly allocate their assets?

☐ Yes  ☐ No  ☐ See my attached written comments

7. Are there any risks that investors will rely too heavily on projected returns without recognizing that their actual returns may be different?

☐ Yes  ☐ No  ☐ See my attached written comments
Contact Information

Name:  
Firm:  
Address:  
City/State/Zip:  
Phone:  
E-Mail:  

Are you:

☐ An NASD Member
☐ An Investor
☐ A Registered Representative
☐ Other:  