

NASD NOTICE TO MEMBERS 97-29

NASD Regulation
Discusses Member
Disclosure Obligations
And Requests Comment
On The Appropriateness
Of Adopting A Rule
Governing Risk
Disclosure; **Comment
Period Expires June 30,
1997**

Suggested Routing

- ☒ Senior Management
- ☒ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☒ Training

Executive Summary

In the following document, NASD Regulation, Inc. (NASD RegulationSM) requests comment on whether a rule should be adopted creating a requirement to disclose investment risks and the absence of guarantees or insurance related to investing in securities products.

Questions concerning this *Request For Comment* should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325; or Mary N. Revell, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

Request For Comment

The NASD encourages all members and other interested parties to respond to the questions raised in this *Notice*. Comments should be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com.

Comments must be received **by June 30, 1997**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD REGULATION REQUEST FOR COMMENT 97-29

Executive Summary

NASD Regulation, Inc. (NASD RegulationSM) reminds members of their disclosure obligations when marketing mutual funds and other securities and requests comment on whether a rule should be adopted creating a requirement to disclose investment risks and the absence of guarantees or insurance related to investing in securities products.

Background

On December 28, 1995, the NASD[®] filed with the Securities and Exchange Commission (SEC) a proposed rule change (NASD Rule 2350) that specifies requirements for broker/dealer conduct on the premises of a financial institution (proposed bank broker/dealer Rule).¹ The purpose of the proposed bank broker/dealer Rule was to address concerns about customer confusion over the distinction between the insured products of financial institutions and the uninsured securities products of broker/dealers operating on the premises of financial institutions and to provide a regulatory framework for regulating bank broker/dealer activities.

The SEC published the proposal in the *Federal Register* on March 22, 1996, requesting comments by May 21, 1996.² The SEC received 98 comments on the proposed Rule. Amendment No. 4 to the proposed Rule, containing revisions responsive to the comments, was filed with the SEC on March 24, 1997.³

The proposed bank broker/dealer Rule specifies the disclosures that a member must make to a customer when the customer opens an account with the member on the premises of a financial institution. Whether the account is opened in person, by telephone, or through some other means, the member must disclose, orally and in writing, that securities products are not insured; are not deposits of, or

guaranteed by, the financial institution; and are subject to investment risks. This disclosure provision was included in the proposed Rule to address concerns over customer assumptions and confusion that the securities purchased from a broker/dealer operating on the premises of a financial institution are either insured or guaranteed against loss of principal.

Some commenters stated that these disclosures should be made by all broker/dealers that sell both insured products and uninsured securities products. They believe that investors who purchase securities through non-financial institution broker/dealers, especially non-financial institution broker/dealers offering Federal Deposit Insurance Corporation (FDIC)-insured products, would benefit equally from these required disclosures. Also, these commenters believe that requiring such disclosure would provide for more equal regulation across different types of member firms.

The NASD Regulation Board of Directors (Board) approved the issuance of this *Notice to Members* discussing disclosure requirements applicable to member sales of insured products and uninsured securities products. The Board also approved seeking public comment on whether a risk disclosure rule is appropriate for all members that sell both FDIC-insured products and uninsured securities products and, if so, how the rule should be structured.

Discussion

The NASD has issued several *Notices to Members* reminding members and their associated persons of their disclosure obligations when recommending the purchase or sale of a mutual fund or any other securities product. *Notices to Members* 91-74 and 93-87 discussed a member's obligations to disclose the material

differences between the risks of uninsured securities products and insured depository products to a customer who is seeking to invest the proceeds of a guaranteed or government-insured depository product, such as a maturing Certificate of Deposit or a bank deposit, in an uninsured securities product, such as a mutual fund, collateralized mortgage obligation, or variable insurance product. *Notice to Members 94-16* and *Special Notice to Members 95-80* reminded members of their obligations to disclose all material information to customers when recommending transactions in mutual funds. Members are encouraged to review these *Notices*.

The obligation to disclose all material facts to a customer is related to the member's requirement under NASD rules to attempt to obtain information from the customer sufficient to determine the suitability of any recommendation to purchase or sell a security.⁴ Broker/dealers also have obligations under federal securities laws, as well as common law, fiduciary duties, to advise customers of the risks of securities transactions.⁵ Disclosure of the risks of investing in a particular securities product relative to other investments or the relative risks and rewards of liquidating an insured product to invest in an uninsured securities product is required if the circumstances surrounding the investment decision lead the member to believe the investor would regard the fact as material to his or her investment objectives and financial situation.⁶

Rule

In addition to the disclosures that are discussed in the above-mentioned *Notices*, members that sell both insured products and uninsured securities products are encouraged to make the risk disclosures required by the bank broker/dealer Rule. While not specifically required by rule,

NASD Regulation believes that customers would benefit from clear disclosure of risks and would thereby be able to make informed investment decisions. Also, broker/dealers operating both on and off the premises of financial institutions would be subject to equal regulation.

As discussed above, the proposed bank broker/dealer Rule specifies the disclosures a member would be required to make to a customer who opens an account with the member on the premises of a financial institution where retail deposits are taken. In particular, the bank broker/dealer Rule would require a member to disclose, orally and in writing, at or prior to the time the member opens an account with a customer, that the securities products purchased or sold in a transaction with the member: (1) are not insured by the FDIC or other deposit insurance; (2) are not deposits or other obligations of a financial institution and are not guaranteed by a financial institution; and (3) are subject to investment risks, including possible loss of the principal invested. The member also would be required to make reasonable efforts to obtain from each customer during the account opening process a written acknowledgment of the required disclosures.

Commenters are asked to address whether a similar rule should be adopted creating an affirmative requirement to disclose investment risks and the absence or presence of guarantees related to investing in particular products. In particular, commenters are asked whether the disclosures that are suggested above are so significant that they ought to be required in every case through a protective rule, or whether general disclosure obligations under federal securities laws, common law, and NASD rules are sufficient to address specific concerns about insured versus uninsured products. If com-

menters believe that a rule should be adopted, comments also are requested on whether such disclosures should be required when a customer transfers funds from an insured product to an uninsured securities product or when a member offers a customer the choice between an insured product and an uninsured securities product. Commenters also are asked to discuss whether the appropriate time for the disclosures required by a rule is when a customer account is opened or at the point of sale. Comments also are requested on whether such a rule should apply only to members selling both insured and uninsured products or to all members. Requiring members that sell only uninsured securities products to provide these disclosures, particularly that securities products are subject to investment risks, including fluctuation in value, would benefit customers who are investing in a securities product either for the first time or after liquidating an insured product.

Questions concerning this *Notice* should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325; or Mary N. Revell, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

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Endnotes

¹ File No. SR-NASD-95-63.

² Release No. 34-36980 (March 15, 1996), 61 FR 11913.

³ See Release No. 34-38506 (April 14, 1997), 62 FR 19378 (April 21, 1997).

⁴ See NASD Rule 2310.

⁵ See Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder; see

also *Leib v. Merrill Lynch, Pierce, Fenner & Smith*, 461 F. Supp. 951, 953 (1978) (common law duties associated with non-discretionary accounts).

⁶ See NASD Notice to Members 94-16.

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