

NASD Notice to Members 98-83

SEC Approves Rule
Change Relating To
Standards For Individual
Correspondence; Effective
November 16, 1998

Suggested Routing

- ☒ Senior Management
- ☒ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☐ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
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- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☒ Training
- ☐ Variable Contracts

Executive Summary

On August 26, 1998, the Securities and Exchange Commission (SEC) approved amendments to the National Association of Securities Dealers, Inc. (NASD[®]) Rule 2210 to require that written or electronic communications prepared for a single customer be subject to the general standards and those specific standards of NASD Rule 2210 that prohibit misleading statements, but not to the specific standards of the rule that prescribe specific disclosure nor the filing and review requirements. The amendments will take effect on November 16, 1998.

Questions concerning this *Notice* may be directed to Thomas A. Pappas, Director, Advertising Regulation, NASD Regulation, Inc. (NASD RegulationSM), at (202) 728-8330, and Robert J. Smith, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Discussion Background

NASD Rule 2210 imposes various requirements on member communications with the public, designed to ensure that those communications are fair, balanced, and not misleading. Rule 2210 does not expressly apply to the content of correspondence (*i.e.*, a communication to only one person). In addition, there is no definition of correspondence in the NASD rules, even though members are required to supervise the use of correspondence by their associated persons under Rule 3010.

NASD Regulation has taken the position that a document prepared for use with a single customer, and not for dissemination to the general public, is not "sales literature" as that term is defined in NASD Rule 2210. However, NASD Regulation believes that applying particular standards in Rule 2210 to correspondence is

appropriate and would enable the staff to bring enforcement actions on the basis of clear violations of certain proscribed behavior.

Discussion

NASD Regulation believes that certain statements pose similar dangers regardless of whether they are communicated to one person or many persons. NASD Regulation recognizes that correspondence is highly individualized in nature and that much correspondence (unlike advertising and sales literature) is directed by registered representatives (RRs) to customers with whom RRs already have an established relationship. At the same time, NASD Regulation believes that clarifying how Rule 2210 applies to correspondence would provide better guidance to the membership and help to assure that investors are adequately protected with respect to the communications they receive individually. The amendments therefore subject correspondence to the general standards and those specific standards of Rule 2210 that prohibit misleading statements, but not to the standards of the rule that prescribe specific disclosure. Members will not have to file correspondence with the NASD for review.

The amendments create a category defined as "communications with the public" to include the current definitions of "advertisement" and "sales literature," and a new definition of "correspondence." "Correspondence" is defined as "...any written or electronic communication prepared for delivery to a single current or prospective customer, and not for dissemination to multiple customers or the general public." In determining when a written or electronic communication is prepared for delivery to a single current or prospective customer, members should consider, and the staff of NASD Regulation will

examine, among other things, the form and content of the communication. Thus, a written or electronic communication addressed to a single current or prospective customer, the content of which is substantially identical to that of written or electronic communications sent to one or more other current or prospective customers, is a form letter, not "correspondence." Because form letters are considered "sales literature" under Rule 2210, they would be subject to all of the general and specific standards of Rule 2210.

The amendments subject individual correspondence to the general standards under subparagraph (d)(1) and the following specific standards under subparagraph (d)(2) of Rule 2210:

- subparagraph (d)(2)(C), which prohibits exaggerated, unwarranted, or certain other specific claims or opinions;
- subparagraph (d)(2)(E), which prohibits certain offers of free services;
- subparagraph (d)(2)(F), which prohibits certain claims for research services;
- subparagraph (d)(2)(G), which prohibits certain hedge clauses;
- subparagraph (d)(2)(J), which prohibits the implication of endorsement or approval by regulatory organizations;
- the provision of subparagraph (d)(2)(L) that prohibits the characterization of income or investment returns as tax exempt or tax free in certain circumstances; and
- subparagraph (d)(2)(N), which prohibits predictions and projections of investment results. All of these specific provisions derive from members' general obligations not to make

statements that are misleading or without a reasonable basis in fact.

Individual correspondence **will not** be subject to the following specific standards of Rule 2210:

- subparagraph (d)(2)(A), which requires the inclusion of certain information regarding members' names;
- subparagraph (d)(2)(B), which requires that a member disclose specified information to the customer when making a recommendation;
- subparagraph (d)(2)(D), which requires the inclusion of certain statements regarding testimonials;
- subparagraph (d)(2)(H), which applies to advertisements for the recruitment of sales personnel;
- subparagraph (d)(2)(I), which requires certain disclosures regarding periodic investment plans;
- subparagraph (d)(2)(K), which requires the identification and disclosure of sources other than the member for certain statistical tables, charts, graphs, or other illustrations;
- the provisions of subparagraph (d)(2)(L) that require the inclusion of clarifying information regarding claims of tax free or tax exempt returns; and
- subparagraph (d)(2)(M), which requires the inclusion of certain information when making comparisons of investment alternatives.

The amendments do not change the current application of Rule IM-2210-1. Therefore paragraph (a) of that rule (interpretation regarding collateralized mortgage obligations) has been amended to clarify that only advertisements and sales literature are covered by the interpretation.

Finally, the amendments also incorporate several minor technical changes that are non-substantive in nature.

Text Of Amendments

(Note: New text is underlined; deletions are bracketed.)

Rule 2210. Communications with the Public

(a) Definitions - Communications with the public shall include:

(1) Advertisement--For purposes of this Rule and any interpretation thereof, "advertisement" means material published, or designed for use in, a newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, telephone directories (other than routine listings), electronic or other public media.

(2) Sales Literature--For purposes of this Rule and any interpretation thereof, "sales literature" means any written or electronic communication distributed or made generally available to customers or the public, which communication does not meet the foregoing definition of "advertisement." Sales literature includes, but is not limited to, circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, and reprints or excerpts of any other advertisement, sales literature or published article.

(3) Correspondence--For purposes of this Rule and any interpretation thereof, "correspondence" means any written or electronic communication prepared for delivery to a single current or prospective customer, and not for dissemination to multiple customers or the general public.

Cross Reference - Rules Concerning Review and Endorsement of Correspondence are Found in paragraph (d) to Conduct Rule 3010.

(b) Approval and Recordkeeping

(1) Each item of advertising and sales literature shall be approved by signature or initial, prior to use or filing with the Association, by a registered principal of the member.

(2) A separate file of all advertisements and sales literature, including the name(s) of the person(s) who prepared them and/or approved their use, shall be maintained for a period of three years from the date of each use.

(c) Filing Requirements and Review Procedures

(1) Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) not included within the requirements of paragraph (c)(2), and public direct participation programs (as defined in Rule 2810) shall be filed with the Association's Advertising/Investment Companies Regulation Department (Department) within 10 days of first use or publication by any member. The member must provide with each filing the actual or anticipated date of first use. Filing in advance of use is recommended. Members are not required to file advertising and sales literature which have previously been filed and which are used without change. Any member filing any investment company advertisement or sales literature pursuant to this paragraph (c) that includes or incorporates rankings or comparisons of the investment company with other investment companies shall include a copy of the ranking or comparison used in the advertisement or sales literature.

(2) Advertisements concerning collateralized mortgage obligations registered under the Securities Act of 1933, and advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) that include or incorporate rankings or comparisons of the investment company with other investment companies where the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, shall be filed with the Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, if expressly disapproved, until the advertisement has been refiled for, and has received, Association approval. The member must provide with each filing the actual or anticipated date of first use. Any member filing any investment company advertisement or sales literature pursuant to this paragraph shall include a copy of the data, ranking or comparison on which the ranking or comparison is based.

(3)(A) Each member of the Association which has not previously filed advertisements with the Association (or with a registered securities exchange having standards comparable to those contained in this Rule) shall file its initial advertisement with the Department at least ten days prior to use and shall continue to file its advertisements at least ten days prior to use for a period of one year. The member must provide with each filing the actual or anticipated date of first use.

(B) Except for advertisements related to exempted securities (as defined in Section 3(a)(12) of the Act), municipal securities, direct participation programs or investment company securities, members subject to the requirements of paragraph (c)(3)(A) [or (B)] of this Rule may, in lieu of filing with the Association, file advertisements on the same basis, and for the same time periods specified in [those] that subparagraph[s], with any registered securities exchange having standards comparable to those contained in this Rule.

(4)(A) Notwithstanding the foregoing provisions, any District Business Conduct Committee of the Association, upon review of a member's advertising and/or sales literature, and after determining that the member has departed and there is a reasonable likelihood that the member will again depart from the standards of this Rule, may require that such member file all advertising and/or sales literature, or the portion of such member's material which is related to any specific types or classes of securities or services, with the Department and/or the District Committee, at least ten days prior to use. The member must provide with each filing the actual or anticipated date of first use.

(B) The Committee shall notify the member in writing of the types of material to be filed and the length of time such requirement is to be in effect. The requirement shall not exceed one year, however, and shall not take effect until 30 days after the member receives the written notice, during which time the member may request a hearing before the District Business Conduct Committee, and any such hearing shall be held in reasonable conformity with the hearing and appeal procedures of the Code of Procedure as contained in the Rule 9000 Series.

(5) In addition to the foregoing requirements, every member's [advertising] advertisements and sales literature shall be subject to a routine spot-check procedure. Upon written request from the Department, each member shall promptly submit the material requested. Members will not be required to submit material under this procedure which has been previously submitted pursuant to one of the foregoing requirements and, except for material related to exempted securities (as defined in Section 3(a)(12) of the Act), municipal securities, direct participation programs or investment company securities, the procedure will not be applied to members who have been, within the Association's current examination cycle subjected to a spot-check by a registered securities exchange or other self-regulatory organization using procedures comparable to those used by the Association.

(6) The following types of material are excluded from the foregoing filing requirements and spot-check procedures:

(A) Advertisements or sales literature solely related to changes in a member's name, personnel, location, ownership, offices, business structure, officers or partners, telephone or teletype numbers, or concerning a merger with, or acquisition by, another member;

(B) Advertisements or sales literature which do no more than identify the Nasdaq symbol of the member and/or of a security in which the member is a Nasdaq registered market maker;

(C) Advertisements or sales literature which do no more than identify the member and/or offer a specific security at a stated price;

(D) Material sent to branch offices or other internal material that is not distributed to the public;

(E) Prospectuses, preliminary prospectuses, offering circulars and similar documents used in connection with an offering of securities which has been registered or filed with the Commission or any state, or which is exempt from such registration, except that an investment company prospectus published pursuant to SEC Rule 482 under the Securities Act of 1933 shall not be considered a prospectus for purposes of this exclusion;

(F) Advertisements prepared in accordance with Section 2(10)(b) of the Securities Act of 1933, as amended, or any rule thereunder, such as SEC Rule 134, unless such advertisements are related to direct participation programs or securities issued by registered investment companies.

(7) Material which refers to investment company securities or direct participation programs, or exempted securities (as defined in Section 3(a)(12) of the Act) solely as part of a listing of products and/or services offered by the member, is excluded from the requirements of subparagraphs (1) and (2).

(d) Standards Applicable to Communications with the Public

(1) General Standards

(A) All member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. No material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause

the [advertising or sales literature] communication to be misleading.

(B) Exaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members. In preparing such [literature] communications, members must bear in mind that inherent in investments are the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield, and no member shall, directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

(C) When sponsoring or participating in a seminar, forum, radio or television interview, or when otherwise engaged in public appearances or speaking activities which may not constitute advertisements, members and persons associated with members shall nevertheless follow the standards of paragraphs (d) and (f) of this Rule.

(D) In judging whether a communication or a particular element of a communication may be misleading, several factors should be considered, including but not limited to:

(i) the overall context in which the statement or statements are made. A statement made in one context may be misleading even though such a statement could be [perfectly] appropriate in another context. An essential test in this regard is the balance of treatment of risks and potential benefits.

(ii) the audience to which the communication is directed. Different levels of explanation or detail may be necessary depending on the audience to which a communication is directed, and the ability of the member given the nature of the media

used, to restrict the audience appropriately. If the statements made in a communication would be applicable only to a limited audience or if additional information might be necessary for other audiences, it should be kept in mind that it is not always possible to restrict the readership of a particular communication.

(iii) the overall clarity of the communication. A statement or disclosure made in an unclear manner [obviously] can result in a lack of understanding of the statement, or in a serious misunderstanding. A complex or overly technical explanation may be [worse] more confusing than too little information. Likewise, material disclosure relegated to legends or footnotes [realistically] may not enhance the reader's understanding of the communication.

(2) Specific Standards

In addition to the foregoing general standards, the following specific standards apply:

(A) Necessary Data. Advertisements and sales literature shall contain the name of the member, unless such advertisements and sales literature comply with paragraph (f). Sales literature shall contain the name of the person or firm preparing the material, if other than the member, and the date on which it is first published, circulated or distributed. If the information in the material is not current, this fact should be stated.

(B) Recommendations.

(i) In making a recommendation in advertisements and sales literature, whether or not labeled as such, a member must have a reasonable basis for the recommendation and must disclose any of the following situations which are applicable:

a. that the member usually makes a market in the securities being recom-

mended, or in the underlying security if the recommended security is an option, [and/]or that the member or associated persons will sell to or buy from customers on a principal basis;

b. that the member and/or its officers or partners own options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;

c. that the member was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years.

(ii) The member shall also provide, or offer to furnish upon request, available investment information supporting the recommendation. Recommendations on behalf of corporate equities must provide the price at the time the recommendation is made.

(iii) A member may use material referring to past recommendations if it sets forth all recommendations as to the same type, kind, grade or classification of securities made by a member within the last year. Longer periods of years may be covered if they are consecutive and include the most recent year. Such material must also name each security recommended and give the date and nature of each recommendation (e.g., whether to buy or sell), the price at the time of the recommendation, the price at which or the price range within which the recommendation was to be acted upon, and indicate the general market conditions during the period covered.

(iv) Also permitted is material which does not make any specific recommendation but which offers to furnish a list of all recommendations made by a member within the past year or over longer periods of consecutive years, including the most recent year, if this list contains all the infor-

mation specified in subparagraph (iii). Neither the list of recommendations, nor material offering such list, shall imply comparable future performance. Reference to the results of a previous specific recommendation, including such a reference in a follow-up research report or market letter, is prohibited if the intent or the effect is to show the success of a past recommendation, unless all of the foregoing requirements with respect to past recommendations are met.

(C) Claims and Opinions. Communications with the public must not contain promises of specific results, exaggerated or unwarranted claims or unwarranted superlatives, opinions for which there is no reasonable basis, or forecasts of future events which are unwarranted, or which are not clearly labeled as forecasts.

(D) Testimonials. In testimonials concerning the quality of a firm's investment advice, the following points must be clearly stated in [the] advertisements or sales literature [communication]:

(i) The testimonial may not be representative of the experience of other clients.

(ii) The testimonial is not indicative of future performance or success.

(iii) If more than a nominal sum is paid, the fact that it is a paid testimonial must be indicated.

(iv) If the testimonial concerns a technical aspect of investing, the person making the testimonial must have knowledge and experience to form a valid opinion.

(E) Offers of Free Service. Any statement in communications with the public to the effect that any report, analysis, or other service will be furnished free or without any charge must not be made unless such

report, analysis or other service actually is or will be furnished entirely free and without condition or obligation.

(F) Claims for Research Facilities. No claim or implication in communications with the public may be made for research or other facilities beyond those which the member actually possesses or has reasonable capacity to provide.

(G) Hedge Clauses. No cautionary statements or caveats, often called hedge clauses, may be used in communications with the public if they are misleading or are inconsistent with the content of the material.

(H) Recruiting Advertising. Advertisements in connection with the recruitment of sales personnel must not contain exaggerated or unwarranted claims or statements about opportunities in the investment banking or securities business and should not refer to specific earnings figures or ranges which are not reasonable under the circumstances.

(I) Periodic Investment Plans. Advertisements and sales literature [Communications with the public] should not discuss or portray any type of continuous or periodic investment plan without disclosing that such a plan does not assure a profit and does not protect against loss in declining markets. In addition, if the material deals specifically with the principles of dollar-cost averaging, it should point out that since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider his financial ability to continue his purchases through periods of low price levels.

(J) References to Regulatory Organizations. Communications with the public shall not make any reference to membership in the Association or to registration or regulation of the

securities being offered, or of the underwriter, sponsor, or any member or associated person, which reference could imply endorsement or approval by the Association or any federal or state regulatory body. References to membership in the Association or Securities Investors Protection Corporation shall comply with all applicable By-Laws and Rules pertaining thereto.

(K) Identification of Sources. Statistical tables, charts, graphs or other illustrations used by members in advertising or sales literature should disclose the source of the information if not prepared by the member.

(L) Claims of Tax Free/Tax Exempt Returns. Income or investment returns may not be characterized in communications with the public as tax free or exempt from income tax where tax liability is merely postponed or deferred. If taxes are payable upon redemption, that fact must be disclosed in advertisements and sales literature. References in advertisements and sales literature to tax free/tax exempt current income must indicate which income taxes apply or which do not unless income is free from all applicable taxes. For example, if income from an investment company investing in municipal bonds may be subject to state or local income taxes, this should be stated, or the illustration should otherwise make it clear that income is free from federal income tax.

(M) Comparisons. In making a comparison in advertisements or sales literature, either directly or indirectly, the member must make certain that the purpose of the comparison is clear and must provide a fair and balanced presentation, including any material differences between the subjects of comparison. Such differences may include investment objectives, sales and management fees, liquidity, safety, guarantees or insur-

ance, fluctuation of principal and/or return, tax features, and any other factors necessary to make such comparisons fair and not misleading.

(N) Predictions and Projections. In communications with the public, if 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.

IM-2210-1. Communications with the Public About Collateralized Mortgage Obligations (CMOs)

(a) General Considerations

For purposes of the following guidelines, the term "collateralized mortgage obligation" (CMO) refers to a multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans. CMOs are also known as "real estate mortgage investment conduits" (REMICs). As a result of the 1986 Tax Reform Act, most CMOs are issued in REMIC form to create certain tax advantages for the issuer. The term CMO and REMIC are now used interchangeably. In order to prevent [a communication about] advertisements and sales literature regarding CMOs from being false or misleading, there are certain factors to be considered, including, but not limited to, the following:

(1) Product Identification

In order to assure that investors understand exactly what security is being discussed, all communications concerning CMOs should clearly describe the product as a "collateralized mortgage obligation." Member firms should not use the proprietary names for CMOs as they do not adequately identify the product. To prevent confusion and the possibility of misleading the reader, communications should not contain comparisons between CMOs and any other investment vehicle, including Certificates of Deposit.

(2) Educational Material

In order to ensure that customers are adequately informed about CMOs members are required to offer to customers educational material which covers the following matters:

(A) A discussion of CMO characteristics as investments and their attendant risks;

(B) An explanation of the structure of a CMO, including the various types of tranches;

(C) A discussion of mortgage loans and mortgage securities;

(D) Features of CMOs, including: credit quality, prepayment rates and average lives, interest rates (including effect on value and prepayment

rates), tax considerations, minimum investments, transactions costs and liquidity;

(E) Questions an investor should ask before investing; and

(F) A glossary of terms that may be helpful to an investor considering an investment.

(3) Safety Claims

A communication should not overstate the relative safety offered by the CMO. Although CMOs generally offer low investment risk, they are subject to market risk like all investment securities and there should be no implication otherwise. Accordingly, references to liquidity should be balanced with disclosure that, upon resale, an investor may receive more or less than his original investment.

(4) Claims About Government Guarantees

(A) Communications should accurately depict the guarantees associated with CMO securities. For example, in most cases it would be misleading to state that CMOs are "government guaranteed" securities. A government agency issue could instead be characterized as government agency backed. Of course, private-issue CMO advertisements should not contain references to guarantees or backing, but may disclose the rating.

(B) If the CMO is offered at a premium, the communication should clearly indicate that the government agency backing applies only to the face value of the CMO, and not to any premium paid. Furthermore, communications should not imply that either the market value or the anticipated yield of the CMO is guaranteed.

(5) Simplicity Claims

CMOs are complex securities and require full, fair and clear disclosure in order to be understood by the investor. A communication should not imply that these are simple securities that may be suitable for any investor seeking high yields. All CMOs do not have the same characteristics and it is misleading to indicate otherwise. Even though two CMOs may have the same underlying collateral, they may differ greatly in their prepayment speed and volatility.

(6) Claims About Predictability

A communication would be misleading if it indicated that the anticipated yield and average life of a CMO were assured. It should disclose that the yield and average life will fluctuate depending on the actual prepayment experience and changes in current interest rates.

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