March 19, 2001

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-01-20**
Notice to Members on the Suitability Rule and Online Communications

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Nancy C. Libin, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8835 or nancy.libin@nasd.com; or James S. Wrona, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8270 or jim.wrona@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan C. Conley
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-01-20
Consists of 27 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(3)(A) under the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission ("SEC" or "Commission") a Notice to Members (Notice to Members 01-23) reminding members that they have suitability obligations when they make recommendations to customers online. The text of the Notice to Members is provided below.

* * *

NASD Notice to Members 01-23

Online Suitability
Suitability Rule And Online Communications

SUGGESTED ROUTING

Senior Management
Legal & Compliance
Executive Representative

KEY TOPICS

Suitability
Online Communications

Executive Summary

In light of the dramatic increase in the use of the Internet for communication between broker/dealers and their customers, NASD Regulation, Inc. (NASD Regulation) is issuing a Policy Statement to provide members[1] with guidance concerning their obligations under the National Association of Securities Dealers, Inc. (NASD®) general suitability rule, Rule 2310,[2] in this electronic environment.[3]

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[1] For purposes of this Policy Statement, the terms "member" and "broker/dealer" include both firms and their associated persons.

[2] NASD Rule 2310 provides in pertinent part:

NASD Regulation filed this Policy Statement on March 19, 2001, with the Securities and Exchange Commission (SEC). Pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(1), the Policy Statement became immediately effective upon filing.

The Policy Statement briefly discusses some of the issues created by the intersection of online activity and the suitability rule. The Policy Statement then provides examples of electronic communications that NASD Regulation considers to be either within or outside the definition of "recommendation" for purposes of the suitability rule.[4] In addition, the Policy Statement sets forth guidelines to assist

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> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
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> (b) Prior to the execution of a transaction recommended to a non-institutional customer, . . . a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member . . . in making recommendations to the customer.

NASD Rule 2310 applies to equity and certain debt securities, but not to municipal securities. Municipal securities are covered by Municipal Securities Rulemaking Board (MSRB) Rule G-19 ("Suitability of Recommendations and Transactions; Discretionary Accounts").

[3] Although the focus of this Policy Statement is on the application of the suitability rule to electronic communications, much of the discussion is also relevant to more traditional communications, such as discussions made in-person, over the telephone, or through postal mail.

[4] This Policy Statement focuses on "customer-specific" suitability under NASD Conduct Rule 2310. The word "recommendation" appears in quotation marks whenever it is discussed in the context of a customer-specific suitability obligation. A broker/dealer must also have a reasonable basis "to believe that the recommendation could be suitable for at least *some* customers." *In re F.J. Kaufman and Company of Virginia*, 50 S.E.C. 164, 168, 1989 SEC LEXIS 2376, *10 (1989) (emphasis in original). This is called "reasonable basis" suitability, and it "relates only to the particular recommendation, rather than to any particular customer." *Id*. *See also In re Charles E. Marland & Co., Inc.*, 45 S.E.C. 632, 636, 1974 SEC LEXIS 2458, *10 (1974) (recommending mutual fund switching creates rebuttable presumption of unsuitability); *In re Thomas Arthur Stewart*, 20 S.E.C. 196, 207, 1945 SEC LEXIS 318, *25 (1945) ("[T]he lack of reasonable grounds for recommending [switching shares of mutual funds]" was the basis for finding broker had violated NASD's suitability rule based on a “reasonable basis” theory.).

Although not directly addressed in this Policy Statement, in certain instances, a suitability violation also can be based on an inappropriate frequency of trades, often referred to as excessive trading or churning. *See* IM-2310-2, Fair Dealing With Customers ("Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are . . . . [e]xcessive activity in a customer's account."). A broker/dealer could violate the suitability rule, for example, where it recommended to a customer an excessive (and, based on the customer’s financial situation and needs, an inappropriate) number of securities transactions and the customer routinely followed the broker/dealer’s recommendations. *See, e.g.*, *In re Harry Gliksman*, Exchange Act Rel. No. 42255, at 4, 1999 SEC LEXIS 2685, at *6 (Dec. 20, 1999) ("Under [Rule 2310], recommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."); *In re Rafael Pinchas*, Exchange Act Rel. No. 41816, at 11-12, 1999 SEC LEXIS 1754, at *22 (Sept. 1,

members in evaluating whether a particular communication could be viewed as a "recommendation," thereby triggering application of the suitability rule.[5]

NASD Regulation emphasizes, however, that this current Policy Statement does not (1) alter member obligations under the suitability rule or (2) establish a "bright line" test for determining whether a communication does or does not constitute a "recommendation" for purposes of the suitability rule. No single factor discussed below, standing alone, necessarily dictates the outcome of the analysis.

NASD Regulation recognizes that brokerage firms are using technology to offer many new beneficial services to customers, and it supports the continued development and use of technology to enhance investor education and access to information. These technological advances may have regulatory implications in the context of rules other than the suitability rule, and, therefore, we expect to issue future statements or guidance on the subject of online activities in the securities industry. NASD Regulation is aware, however, that technology is developing rapidly, and we want to avoid impeding the growth of new technological services for investors.

Questions/Further Information

Questions or comments concerning the information contained in this Policy Statement may be directed to either Nancy C. Libin, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8835 or *nancy.libin@nasd.com*, or James S. Wrona, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8270 or *jim.wrona@nasd.com.*

NASD Regulation Policy Statement Regarding Application Of The NASD Suitability Rule To Online Communications

Background

Technological developments in recent years have profoundly affected the securities industry.[6] One of the most dramatic changes is the way in which brokerage firms use the Internet to communicate with their customers. In addition to more traditional channels of communication such as the telephone and postal mail, broker/dealers and customers now transmit information to each other through broker/dealers' Web Sites, e-mail, Web phones, personal digital assistants, and hand-held pagers. Broker/dealers also use the Internet to provide lower-cost, unbundled services to customers. Among other things, broker/dealers have used the Internet to provide investors with new tools to obtain access

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1999) ("[E]xcessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading.").

[5] While other NASD rules may cover circumstances where members are making recommendations (*see, e.g.*, Rule 2210, "Communications with the Public"), this Policy Statement is limited to a discussion of the suitability rule.

[6] *See* SEC Guidance on the Use of Electronic Media ("Use of Electronic Media"), Release Nos. 34-7856, 34-42728, IC-24426, 65 Fed. Reg. 25843, 25843, 2000 SEC LEXIS 847, at *4 (Apr. 28, 2000) ("By facilitating rapid and widespread information dissemination, the Internet has had a significant impact on capital-raising techniques and, more broadly, on the structure of the securities industry.").

to important analytical information, conduct their own research, and place their own orders. Technological advancements have provided many benefits to investors and the brokerage industry. These technological innovations, however, also have presented new regulatory challenges, including those arising from the application of the suitability rule to online activities.

The NASD's suitability rule states that in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer. As the rule states, a member's suitability obligation applies to securities that the member "recommends" to a customer.[7] The NASD's suitability rule generally has been violated when a broker/dealer "recommends" a security to a customer that might be suitable for some investors, but is unsuitable for that particular customer.

Applicability Of The Suitability Rule To Electronic Communications

There has been much debate recently about the application of the suitability rule to online activities.[8] Two major questions have arisen: first, whether the current suitability rule should even apply to online

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[7] A member or associated person who simply effects a trade initiated by a customer without a related "recommendation" from the member or associated person is not required to perform a suitability analysis, although members may elect to determine whether a security is suitable under such circumstances for their own business reasons. *See In re Thomas E. Warren, III*, 51 S.E.C. 1015, 1019 n.19, 1994 SEC LEXIS 508, *11 n.19 (1994) ("We do not believe the suitability claims brought against the Applicant are supported by the record. There is no evidence that Warren recommended the transactions that were effected in these accounts."), *aff'd*, 69 F.3d 549 (10th Cir. 1995) (table format); SEC Announcement of Final Rule on Sales Practice Requirements for Certain Low-Priced Securities, Release No. 34-27160, 54 Fed. Reg. 35468, 1989 SEC LEXIS 1603, at *52 (Aug. 22, 1989) ("[T]he NASD and other suitability rules have long applied only to 'recommended' transactions."); Clarification of Notice to Members ("NtM") 96-60, 1997 NASD LEXIS 20 (FYI, Mar. 1997) (stating that a member's suitability obligation under Rule 2310 applies only to securities that have been recommended by the member). Similarly, the suitability rule does not apply where a member merely gathers information on a particular customer, but does not make any "recommendations." This is true even if the information is the type of information generally gathered to satisfy a suitability obligation.

Members should nonetheless remember that, under NASD Rule 2110, they are required to comply with know-your-customer obligations. Pursuant to these obligations, members must make reasonable efforts to obtain certain basic financial information from customers so that members can protect themselves and the integrity of the securities markets from customers who do not have the financial means to pay for transactions. *See* NtM 96-32, 1996 NASD LEXIS 51 (May 1996) (reminding members of their know-your-customer obligations), *supplemented and clarified on different grounds by* NtM 96-60 (Sept. 1996); *see also* NtM 99-11, 1999 NASD LEXIS 77 (Feb. 1999) ("While [this Notice] does not address firms' suitability obligations in connection with recommended transactions or their know-your-customer obligations, firms are reminded that the existence of these obligations does not depend upon whether a trade is executed on-line or otherwise."); NtM 98-66, 1998 NASD LEXIS 81 (Aug. 1998) (noting that members should provide a description of "any internal system protocols designed to fulfill a member's 'know your customer' obligations"). Unlike the suitability rule, the NASD's know-your-customer requirements apply to members regardless of whether they have made a "recommendation."

[8] *See generally* SEC Commissioner Laura Unger, *Online Brokerage: Keeping Apace of Cyberspace* (Nov. 1999) ("Unger Report") (discussing various views espoused by online brokerage firms, regulators and academics on the topic of online suitability). The Unger Report can be accessed through the SEC Web Site at www.sec.gov/news/spstindx.htm (last modified on May 4, 2000). *See also Developments in the Law—The Law of Cyberspace*, 112 HARV. L. REV. 1574, 1582-83 (1999) (The article highlights the broader debate by academics and judges over whether "to apply conventional models of regulation to the Internet.").

activities, and second, if so, what types of online communications constitute "recommendations" for purposes of the rule.

In answer to the first question, NASD Regulation believes that the suitability rule applies to all "recommendations" made by members to customers—including those made via electronic means—to purchase, sell, or exchange a security. Electronic communications from broker/dealers to their customers clearly can constitute "recommendations." The suitability rule, therefore, remains fully applicable to online activities in those cases where the member "recommends" securities to its customers.

With regard to the second question, NASD Regulation does not seek to identify in this Policy Statement all of the types of electronic communications that may constitute "recommendations." As NASD Regulation has often emphasized, "[w]hether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances."[9] That is, the test for determining whether any communication (electronic or traditional) constitutes a "recommendation" remains a "facts and circumstances" inquiry to be conducted on a case-by-case basis.

NASD Regulation also recognizes that many forms of electronic communications defy easy characterization. Nevertheless, we offer as guidance the following general principles for member firms to use in determining whether a particular communication could be deemed a "recommendation." As illustrated by the examples provided below, the "facts and circumstances" determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation—a particular communication from a broker/dealer to a customer reasonably would be viewed as a "call to action," or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances, such as any accompanying explanatory message from the broker/dealer.[10] Another principle that members should keep in mind is that, in general, the more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation."[11]

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[9] Clarification of NtM 96-60, 1997 NASD LEXIS 20 (FYI, Mar. 1997).

[10] For example, if a broker/dealer transmitted a research report to a customer at the customer's request, that communication may not be subject to the suitability rule; whereas, if the same broker/dealer transmitted the very same research report with an accompanying message, either oral or written, that the customer should act on the report, the suitability analysis would be different.

[11] *See Online Brokerage Services and the Suitability Rule*, NASD REGULATORY & COMPLIANCE ALERT , at 20 (Summer 2000) (noting that the more individualized and particular the communication about a security, the closer the communication is to being viewed as a "recommendation"). The REGULATORY & COMPLIANCE ALERT article is also available at www.nasdr.com/rca_summer00.htm. *See also* Thomas L. Taylor III & Alan S. Petlak, *Q&A Online:*

Scope Of The Term "Recommendation": Examples

In order to provide guidance to members, NASD Regulation offers some examples of electronic communications that could be viewed as within or outside the definition of "recommendation." These examples are intended to show the application of the above-mentioned general principles.

In addition to when a member acts merely as an order-taker regarding a particular transaction,[12] NASD Regulation generally would view the following activities and communications as falling outside the definition of "recommendation":

- A member creates a Web Site that is available to customers or groups of customers. The Web Site has research pages or "electronic libraries" that contain research reports (which may include buy/sell recommendations from the author of the report), news, quotes, and charts that customers can obtain or request.

- A member has a search engine on its Web Site that enables customers to sort through the data available about the performance of a broad range of stocks and mutual funds, company fundamentals, and industry sectors. The data is not limited, for instance, to, and does not favor, securities in which the member makes a market or has made a "buy" recommendation. Customers use and direct this tool on their own. Search results from this tool may rank securities using any criteria selected by the customer, and may display current news, quotes, and links to related sites.[13]

- A member provides research tools on its Web Site that allow customers to screen through a wide universe of securities (e.g., all exchange-listed and Nasdaq securities) or an externally recognized group of securities (e.g., certain indexes) and to request lists of securities that meet broad, objective criteria (e.g., all companies in a certain sector with 25 percent annual earnings growth). The member does not impose limits on the manner in which the research tool searches through a wide universe of securities, nor does it control the generation of the list in order to favor certain securities. For instance, the member does not limit the universe of

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Chat, Research, COMPLIANCE REPORTER , July 31, 2000, at 11 (stating that a factor to consider when determining whether a communication is a "recommendation" is the degree to which it is individualized and specific).

[12] See *supra* note 7 and accompanying text.

[13] Note, however, that hyperlinks conceivably could create suitability obligations, depending, for example, on the information provided to and from the hyperlinked site, the extent to which a member endorses the content of the hyperlinked site, the nature of the firm's relationship to the hyperlinked site, and other attendant facts and circumstances. It should also be noted that NASD Regulation has previously issued guidance regarding the responsibility of members for the content of hyperlinked sites. *See* Letter from Thomas Selman, Vice President, NASD Regulation, Disclosure and Investor Protection to Craig Tyle, General Counsel, Investment Company Institute, Nov. 11, 1997. This letter can be accessed through NASD Regulation's Web Site at *www.nasdr.com /2910/2210_01.htm*. *See also* Use of Electronic Media, *supra* note 6, at 65 Fed. Reg. at 25848-25849, *32-49 (discussing responsibility for hyperlinked information). In addition, NASD Regulation has provided guidance to firms regarding the use of "chat rooms" and "bulletin boards." *See* NtM 96-50, 1996 NASD LEXIS 60 (July 1996).

securities to those in which it makes a market or for which it has made a "buy" recommendation. Similarly, the algorithms for these tools are not programmed to produce lists of securities based on subjective factors that the member has created or developed, nor do the algorithms, for example, produce lists that favor those securities in which the member makes a market or for which the member has made a "buy" recommendation.

- A member allows customers to subscribe to e-mails or other electronic communications that alert customers to news affecting the securities in the customer's portfolio or on the customer's "watch list." Such news might include price changes, notice of pre-scheduled events (such as an imminent bond maturation), or generalized information. The customer selects the scope of the information that the firm will send to him or her.

NASD Regulation generally would view the following communications as falling within the definition of "recommendation":

- A member sends a customer-specific electronic communication (e.g., an e-mail or pop-up screen) to a targeted customer or targeted group of customers encouraging the particular customer(s) to purchase a security.[14]

- A member sends its customers an e-mail stating that customers should be invested in stocks from a particular sector (such as technology) and urges customers to purchase one or more stocks from a list with "buy" recommendations.

- A member provides a portfolio analysis tool that allows a customer to indicate an investment goal and input personalized information such as age, financial condition, and risk tolerance. The member in this instance then sends (or displays to) the customer a list of specific securities the customer could buy or sell to meet the investment goal the customer has indicated.[15]

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[14] Note that there are instances where sending a customer an electronic communication that highlights a particular security (or securities) will not be viewed as a "recommendation." For instance, while each case requires an analysis of the particular facts and circumstances, a member generally would not be viewed as making a "recommendation" when, pursuant to a customer's request, it sends the customer (1) electronic "alerts" (such as account activity alerts, market alerts, or price, volume, and earnings alerts) or (2) research announcements (e.g., a firm's "stock of the week") that are not tailored to the individual customer, as long as neither—given their content, context, and manner of presentation—would lead a customer reasonably to believe that the firm is suggesting that the customer take action in response to the communication.

[15] Note, however, that a portfolio analysis tool that merely generates a suggested mix of general classes of financial assets (e.g., 60 percent equities, 20 percent bonds, and 20 percent cash equivalents), without an accompanying list of securities that the customer could purchase to achieve that allocation, would not trigger a suitability obligation. On the other hand, a series of actions which may not constitute "recommendations" when considered individually, may amount to a "recommendation" when considered in the aggregate. For example, a portfolio allocator's suggestion that a customer could alter his or her current mix of investments followed by provision of a list of securities that could be purchased or sold to accomplish the alteration could be a "recommendation." Again, however, the determination of whether a portfolio analysis tool's communication constitutes a "recommendation" will depend on the content, context, and presentation of the communication or series of communications.

- A member uses data-mining technology (the electronic collection of information on Web Site users) to analyze a customer's financial or online activity—whether or not known by the customer—and then, based on those observations, sends (or "pushes") specific investment suggestions that the customer purchase or sell a security.

Members should keep in mind that these examples are meant only to provide guidance and are not an exhaustive list of communications that NASD Regulation does or does not consider to be "recommendations." As stated earlier, many other types of electronic communications are not easily characterized. In addition, changes to the factual predicates upon which these examples are based (or the existence of additional factors) could alter the determination of whether similar communications may or may not be viewed as "recommendations." Members, therefore, should analyze all relevant facts and circumstances, bearing in mind the general principles noted earlier and discussed below, to determine whether a communication is a "recommendation," and they should take the necessary steps to fulfill their suitability obligations. Furthermore, these examples are based on technological services that are currently used in the marketplace. They are not intended to direct or limit the future development of delivery methods or products and services provided online.

Guidelines For Evaluating Suitability Obligations

NASD Regulation believes that members should consider, at a minimum, the following guidelines when evaluating their suitability obligations. None of these guidelines is determinative. Each is but one factor to be considered in evaluating all of the facts and circumstances surrounding the communication.

- A member cannot avoid or discharge its suitability obligation through a disclaimer where the particular communication reasonably would be viewed as a "recommendation" given its content, context, and presentation.[16] NASD Regulation, however, encourages members to include on their Web Sites (and in other means of communication with their customers) clear explanations of the use and limitations of tools offered on those sites.

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[16] Although, as noted previously, a broker/dealer cannot disclaim away its suitability obligation, informing customers that generalized information provided is not based on the customer's particular financial situation or needs may help clarify that the information provided is not meant to be a "recommendation" to the customer. Whether the communication is in fact a "recommendation" would still depend on the content, context, and presentation of the communication. Accordingly, a member that sends a customer or group of customers information about a security might include a statement that the member is not providing the information based on the customers' particular financial situations or needs. Members may properly disclose to customers that the opinions or recommendations expressed in research do not take into account individual investors' circumstances and are not intended to represent "recommendations" by the member of particular stocks to particular customers.

Members, however, should refer to previous guidelines issued by the SEC and NASD that may be relevant to these and/or related topics. For instance, the SEC has issued guidelines regarding whether and under what circumstances third-party information is attributable to an issuer, and the SEC noted that the guidance also may be relevant regarding the responsibilities of broker/dealers. Use of Electronic Media, *supra* note 6, at 65 Fed. Reg. at 25848-25849, *32-49 (discussing entanglement and adoption theories). *See also supra* note 13 and discussion therein.

- Members should analyze any communication about a security that reasonably could be viewed as a "call to action" and that they direct or appear to direct to a particular individual or targeted group of individuals—as opposed to statements that are generally made available to all customers or the public at large—to determine whether a "recommendation" is being made.[17]

- Members should scrutinize any communication to a customer that suggests the purchase, sale, or exchange of a security—as opposed to simply providing objective data about a security—to determine whether a "recommendation" is being made.[18]

- A member's transmission of unrequested information will not necessarily constitute a "recommendation." However, when a member decides to send a particular customer unrequested information about a security that is not of a generalized or administrative nature (e.g., notification of a stock split or a dividend), the member should carefully review the circumstances under which the information is being provided, the manner in which the information is delivered to the customer, the content of the communication, and the original source of the information. The member should perform this review regardless of whether the decision to send the information is made by a representative employed by the member or by a computer software program used by the member.

- Members should be aware that the degree to which the communication reasonably would influence an investor to trade a particular security or group of securities—either through the context or manner of presentation or the language used in the communication—may be considered in determining whether a "recommendation" is being made to the customer.

NASD Regulation emphasizes that the factors listed above are guidelines that may assist members in complying with the suitability rule. Again, the presence or absence of any of these factors does not by itself control whether a "recommendation" has been made or whether the member has complied with the suitability rule. Such determinations can be made only on a case-by-case basis taking into account all of the relevant facts and circumstances.

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[17] We note that there are circumstances where the act of sending a communication to a specific group of customers will not necessarily implicate the suitability rule. For instance, a broker/dealer's business decision to provide only certain types of investment information (e.g., research reports) to a category of "premium" customers would not, without more, trigger application of the suitability rule. Conversely, members may incur suitability obligations when they send a communication to a large group of customers urging those customers to invest in a security.

[18] As with the other general guidelines discussed in this Policy Statement, the presence of this factor alone does not automatically mean that a "recommendation" has been made. For example, where a customer affirmatively requests to be alerted (by e-mail or pop-up screen) when a security reaches a specific price-point, when a company issues an earnings release, or when an analyst changes his or her recommendation of a particular security, the broker/dealer's decision to send the customer the requested information, without more, would not necessarily trigger a suitability obligation.

Conclusion

The foregoing discussion highlights some suggested guidelines to assist in determining when electronic communications constitute "recommendations," thereby triggering application of the NASD's suitability rule. NASD Regulation acknowledges the numerous benefits that are enjoyed by members and their customers as a result of the Internet and online brokerage services. NASD Regulation emphasizes that it neither takes a position on nor seeks to influence any firm's or customer's choice of a particular business model in this electronic environment. At the same time, however, NASD Regulation urges members both to consider all compliance implications when implementing new services and to remember that customers' best interests must continue to be of paramount importance in any setting, traditional or online.

As new technologies and/or services evolve, NASD Regulation will continue to provide statements or guidance regarding the application of the suitability rule and other rules.[19] To date, NASD Regulation has worked to resolve various suitability-related issues with federal and state regulators, NASD Regulation's e-Brokerage Committee, the NASD's Legal Advisory Board and Small Firm Advisory Board, NASD Regulation's Standing and District Committees, and the NASD membership. This open dialogue has been beneficial, and NASD Regulation will continue to work with regulators, members of the industry and the public on these and other important issues that arise in the online brokerage environment.

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(b) This Notice to Members provides members with guidance on the application of the suitability rule, NASD Rule 2310, to online communications.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The Notice to Members was approved by the Board of Directors of NASD Regulation at its meeting on December 6, 2000. The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the Notice to Members pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the Notice to Members at its meeting on

[19] In this regard, NASD Regulation is considering further discussion of the application of the suitability rule to electronic communications involving initial public offerings in future guidance.

December 7, 2000. The Executive Committee of the NASD Board of Governors approved the filing of the Notice to Members at its meeting on March 19, 2001. No other action by the NASD is necessary for the filing of the Notice to Members. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to issue interpretations of NASD Rules without recourse to the membership for approval.

(b) Questions regarding this rule filing may be directed to Nancy C. Libin, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8835, or James S. Wrona, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8270.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Member firms are increasingly offering online brokerage services to their retail customers. The Internet gives retail customers the tools to manage their own accounts and conduct their own trading activity and the ability to obtain access to an unprecedented amount of information. Online trading offers many benefits to member firms and retail customers, but member firms must continue to fulfill their suitability obligations in the online environment whenever they "recommend" to a customer the purchase, sale, or exchange of a security.

The Notice to Members states that the suitability rule (NASD Rule 2310) remains fully applicable to online activities in those cases where a member "recommends" securities transactions to its customers. The Notice to Members does not expand or create any new obligations under the suitability rule, nor does it establish a "bright line" test for determining whether a particular

communication constitutes a "recommendation" for purposes of the suitability rule. NASD Regulation instead provides guidance to members through the use of examples of communications that NASD Regulation generally would view as falling within and outside the definition of "recommendation." The Notice to Members also articulates several broad principles that member firms can use in evaluating whether a particular online communication could fall within the definition of "recommendation" for purposes of the suitability rule.

(b) Statutory Basis

NASD Regulation believes that the Notice to Members is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that member firms that make "recommendations" to customers in the online environment have an obligation to determine whether the "recommendations" are suitable for such customers. NASD Regulation believes that this Notice to Members is necessary to protect investors and the public interest with respect to online brokerage activities.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the Notice to Members will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended. The Notice to Members merely reminds members that they have suitability obligations when they make "recommendations" to customers online.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

Not applicable.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3)

The Notice to Members is effective upon filing pursuant to Section 19(b)(3)(A) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder, in that the Notice to Members is a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed Notice to Members for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY:_____
Joan C. Conley, Senior Vice President
and Corporate Secretary

Date: March 19, 2001

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34 ; File No. SR-NASD-01-20)

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Suitability Rule and Online Communications

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[20] and Rule 19b-4 thereunder,[21] notice is hereby given that on March 19, 2001, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") a Notice to Members (Notice to Members 01-23) as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Notice to Members is effective upon filing pursuant to Section 19(b)(3)(A) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder, in that the Notice to Members is a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule. For the reasons discussed below, the Commission is granting accelerated approval of the Notice to Members.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is issuing a Notice to Members reminding members that they have suitability obligations when they make recommendations to customers online. The text of the Notice to Members is provided below.

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[20] 15 U.S.C. 78s(b)(1).

[21] 17 CFR 240.19b-4.

* * *

NASD Notice to Members 01-23

Online Suitability
Suitability Rule And Online Communications

SUGGESTED ROUTING

Senior Management
Legal & Compliance
Executive Representative

KEY TOPICS

Suitability
Online Communications

Executive Summary

In light of the dramatic increase in the use of the Internet for communication between broker/dealers and their customers, NASD Regulation, Inc. (NASD Regulation) is issuing a Policy Statement to provide members[1] with guidance concerning their obligations under the National Association of Securities Dealers, Inc. (NASD®) general suitability rule, Rule 2310,[2] in this electronic environment.[3]

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[1] For purposes of this Policy Statement, the terms "member" and "broker/dealer" include both firms and their associated persons.

[2] NASD Rule 2310 provides in pertinent part:

> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
>
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, . . . a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member . . . in making recommendations to the customer.

NASD Rule 2310 applies to equity and certain debt securities, but not to municipal securities. Municipal securities are covered by Municipal Securities Rulemaking Board (MSRB) Rule G-19 ("Suitability of Recommendations and Transactions; Discretionary Accounts").

NASD Regulation filed this Policy Statement on March 19, 2001, with the Securities and Exchange Commission (SEC). Pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(1), the Policy Statement became immediately effective upon filing.

The Policy Statement briefly discusses some of the issues created by the intersection of online activity and the suitability rule. The Policy Statement then provides examples of electronic communications that NASD Regulation considers to be either within or outside the definition of "recommendation" for purposes of the suitability rule.[4] In addition, the Policy Statement sets forth guidelines to assist members in evaluating whether a particular communication could be viewed as a "recommendation," thereby triggering application of the suitability rule.[5]

NASD Regulation emphasizes, however, that this current Policy Statement does not (1) alter member obligations under the suitability rule or (2) establish a "bright line" test for determining whether a communication does or does not constitute a "recommendation" for purposes of the suitability rule. No single factor discussed below, standing alone, necessarily dictates the outcome of the analysis.

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[3] Although the focus of this Policy Statement is on the application of the suitability rule to electronic communications, much of the discussion is also relevant to more traditional communications, such as discussions made in-person, over the telephone, or through postal mail.

[4] This Policy Statement focuses on "customer-specific" suitability under NASD Conduct Rule 2310. The word "recommendation" appears in quotation marks whenever it is discussed in the context of a customer-specific suitability obligation. A broker/dealer must also have a reasonable basis "to believe that the recommendation could be suitable for at least *some* customers." *In re F.J. Kaufman and Company of Virginia*, 50 S.E.C. 164, 168, 1989 SEC LEXIS 2376, *10 (1989) (emphasis in original). This is called "reasonable basis" suitability, and it "relates only to the particular recommendation, rather than to any particular customer." *Id*. *See also In re Charles E. Marland & Co., Inc.*, 45 S.E.C. 632, 636, 1974 SEC LEXIS 2458, *10 (1974) (recommending mutual fund switching creates rebuttable presumption of unsuitability); *In re Thomas Arthur Stewart*, 20 S.E.C. 196, 207, 1945 SEC LEXIS 318, *25 (1945) ("[T]he lack of reasonable grounds for recommending [switching shares of mutual funds]" was the basis for finding broker had violated NASD's suitability rule based on a “reasonable basis” theory.).

Although not directly addressed in this Policy Statement, in certain instances, a suitability violation also can be based on an inappropriate frequency of trades, often referred to as excessive trading or churning. *See* IM-2310-2, Fair Dealing With Customers ("Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are . . . . [e]xcessive activity in a customer's account."). A broker/dealer could violate the suitability rule, for example, where it recommended to a customer an excessive (and, based on the customer’s financial situation and needs, an inappropriate) number of securities transactions and the customer routinely followed the broker/dealer’s recommendations. *See, e.g.*, *In re Harry Gliksman*, Exchange Act Rel. No. 42255, at 4, 1999 SEC LEXIS 2685, at *6 (Dec. 20, 1999) ("Under [Rule 2310], recommendations may be unsuitable if the trading is excessive based on the customer's objectives and financial situation."); *In re Rafael Pinchas*, Exchange Act Rel. No. 41816, at 11-12, 1999 SEC LEXIS 1754, at *22 (Sept. 1, 1999) ("[E]xcessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading.").

[5] While other NASD rules may cover circumstances where members are making recommendations (*see, e.g.*, Rule 2210, "Communications with the Public"), this Policy Statement is limited to a discussion of the suitability rule.

NASD Regulation recognizes that brokerage firms are using technology to offer many new beneficial services to customers, and it supports the continued development and use of technology to enhance investor education and access to information. These technological advances may have regulatory implications in the context of rules other than the suitability rule, and, therefore, we expect to issue future statements or guidance on the subject of online activities in the securities industry. NASD Regulation is aware, however, that technology is developing rapidly, and we want to avoid impeding the growth of new technological services for investors.

Questions/Further Information

Questions or comments concerning the information contained in this Policy Statement may be directed to either Nancy C. Libin, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8835 or *nancy.libin@nasd.com*, or James S. Wrona, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8270 or *jim.wrona@nasd.com.*

NASD Regulation Policy Statement Regarding Application Of The NASD Suitability Rule To Online Communications

Background

Technological developments in recent years have profoundly affected the securities industry.[6] One of the most dramatic changes is the way in which brokerage firms use the Internet to communicate with their customers. In addition to more traditional channels of communication such as the telephone and postal mail, broker/dealers and customers now transmit information to each other through broker/dealers' Web Sites, e-mail, Web phones, personal digital assistants, and hand-held pagers. Broker/dealers also use the Internet to provide lower-cost, unbundled services to customers. Among other things, broker/dealers have used the Internet to provide investors with new tools to obtain access to important analytical information, conduct their own research, and place their own orders. Technological advancements have provided many benefits to investors and the brokerage industry. These technological innovations, however, also have presented new regulatory challenges, including those arising from the application of the suitability rule to online activities.

The NASD's suitability rule states that in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer. As the rule states, a member's suitability obligation applies to securities that the member "recommends" to a customer.[7] The NASD's suitability rule

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[6] *See* SEC Guidance on the Use of Electronic Media ("Use of Electronic Media"), Release Nos. 34-7856, 34-42728, IC-24426, 65 Fed. Reg. 25843, 25843, 2000 SEC LEXIS 847, at *4 (Apr. 28, 2000) ("By facilitating rapid and widespread information dissemination, the Internet has had a significant impact on capital-raising techniques and, more broadly, on the structure of the securities industry.").

[7] A member or associated person who simply effects a trade initiated by a customer without a related "recommendation" from the member or associated person is not required to perform a suitability analysis, although members may elect to determine whether a security is suitable under such circumstances for their own business reasons. *See In re Thomas E. Warren, III*, 51 S.E.C. 1015, 1019 n.19, 1994 SEC LEXIS 508, *11 n.19 (1994) ("We do not believe the suitability claims brought against the Applicant are supported by the record. There is no evidence that Warren recommended the transactions that were effected in these accounts."), *aff'd*, 69 F.3d 549

generally has been violated when a broker/dealer "recommends" a security to a customer that might be suitable for some investors, but is unsuitable for that particular customer.

Applicability Of The Suitability Rule To Electronic Communications

There has been much debate recently about the application of the suitability rule to online activities.[8] Two major questions have arisen: first, whether the current suitability rule should even apply to online activities, and second, if so, what types of online communications constitute "recommendations" for purposes of the rule.

In answer to the first question, NASD Regulation believes that the suitability rule applies to all "recommendations" made by members to customers—including those made via electronic means—to purchase, sell, or exchange a security. Electronic communications from broker/dealers to their customers clearly can constitute "recommendations." The suitability rule, therefore, remains fully applicable to online activities in those cases where the member "recommends" securities to its customers.

With regard to the second question, NASD Regulation does not seek to identify in this Policy Statement all of the types of electronic communications that may constitute "recommendations." As NASD Regulation has often emphasized, "[w]hether a particular transaction is in fact recommended

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(10th Cir. 1995) (table format); SEC Announcement of Final Rule on Sales Practice Requirements for Certain Low-Priced Securities, Release No. 34-27160, 54 Fed. Reg. 35468, 1989 SEC LEXIS 1603, at *52 (Aug. 22, 1989) ("[T]he NASD and other suitability rules have long applied only to 'recommended' transactions."); Clarification of Notice to Members ("NtM") 96-60, 1997 NASD LEXIS 20 (FYI, Mar. 1997) (stating that a member's suitability obligation under Rule 2310 applies only to securities that have been recommended by the member). Similarly, the suitability rule does not apply where a member merely gathers information on a particular customer, but does not make any "recommendations." This is true even if the information is the type of information generally gathered to satisfy a suitability obligation.

Members should nonetheless remember that, under NASD Rule 2110, they are required to comply with know-your-customer obligations. Pursuant to these obligations, members must make reasonable efforts to obtain certain basic financial information from customers so that members can protect themselves and the integrity of the securities markets from customers who do not have the financial means to pay for transactions. *See* NtM 96-32, 1996 NASD LEXIS 51 (May 1996) (reminding members of their know-your-customer obligations), *supplemented and clarified on different grounds by* NtM 96-60 (Sept. 1996); *see also* NtM 99-11, 1999 NASD LEXIS 77 (Feb. 1999) ("While [this Notice] does not address firms' suitability obligations in connection with recommended transactions or their know-your-customer obligations, firms are reminded that the existence of these obligations does not depend upon whether a trade is executed on-line or otherwise."); NtM 98-66, 1998 NASD LEXIS 81 (Aug. 1998) (noting that members should provide a description of "any internal system protocols designed to fulfill a member's 'know your customer' obligations"). Unlike the suitability rule, the NASD's know-your-customer requirements apply to members regardless of whether they have made a "recommendation."

[8] *See generally* SEC Commissioner Laura Unger, *Online Brokerage: Keeping Apace of Cyberspace* (Nov. 1999) ("Unger Report") (discussing various views espoused by online brokerage firms, regulators and academics on the topic of online suitability). The Unger Report can be accessed through the SEC Web Site at www.sec.gov/news/spstindx.htm (last modified on May 4, 2000). *See also Developments in the Law—The Law of Cyberspace*, 112 HARV. L. REV. 1574, 1582-83 (1999) (The article highlights the broader debate by academics and judges over whether "to apply conventional models of regulation to the Internet.").

depends on an analysis of all the relevant facts and circumstances."[9] That is, the test for determining whether any communication (electronic or traditional) constitutes a "recommendation" remains a "facts and circumstances" inquiry to be conducted on a case-by-case basis.

NASD Regulation also recognizes that many forms of electronic communications defy easy characterization. Nevertheless, we offer as guidance the following general principles for member firms to use in determining whether a particular communication could be deemed a "recommendation." As illustrated by the examples provided below, the "facts and circumstances" determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation—a particular communication from a broker/dealer to a customer reasonably would be viewed as a "call to action," or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances, such as any accompanying explanatory message from the broker/dealer.[10] Another principle that members should keep in mind is that, in general, the more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation."[11]

Scope Of The Term "Recommendation": Examples

In order to provide guidance to members, NASD Regulation offers some examples of electronic communications that could be viewed as within or outside the definition of "recommendation." These examples are intended to show the application of the above-mentioned general principles.

In addition to when a member acts merely as an order-taker regarding a particular transaction,[12] NASD Regulation generally would view the following activities and communications as falling outside the definition of "recommendation":

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9 Clarification of NtM 96-60, 1997 NASD LEXIS 20 (FYI, Mar. 1997).

10 For example, if a broker/dealer transmitted a research report to a customer at the customer's request, that communication may not be subject to the suitability rule; whereas, if the same broker/dealer transmitted the very same research report with an accompanying message, either oral or written, that the customer should act on the report, the suitability analysis would be different.

11 *See Online Brokerage Services and the Suitability Rule*, NASD REGULATORY & COMPLIANCE ALERT , at 20 (Summer 2000) (noting that the more individualized and particular the communication about a security, the closer the communication is to being viewed as a "recommendation"). The REGULATORY & COMPLIANCE ALERT article is also available at www.nasdr.com/rca_summer00.htm. *See also* Thomas L. Taylor III & Alan S. Petlak, *Q&A Online: Chat, Research*, COMPLIANCE REPORTER , July 31, 2000, at 11 (stating that a factor to consider when determining whether a communication is a "recommendation" is the degree to which it is individualized and specific).

12 See *supra* note 7 and accompanying text.

- A member creates a Web Site that is available to customers or groups of customers. The Web Site has research pages or "electronic libraries" that contain research reports (which may include buy/sell recommendations from the author of the report), news, quotes, and charts that customers can obtain or request.

- A member has a search engine on its Web Site that enables customers to sort through the data available about the performance of a broad range of stocks and mutual funds, company fundamentals, and industry sectors. The data is not limited, for instance, to, and does not favor, securities in which the member makes a market or has made a "buy" recommendation. Customers use and direct this tool on their own. Search results from this tool may rank securities using any criteria selected by the customer, and may display current news, quotes, and links to related sites.[13]

- A member provides research tools on its Web Site that allow customers to screen through a wide universe of securities (e.g., all exchange-listed and Nasdaq securities) or an externally recognized group of securities (e.g., certain indexes) and to request lists of securities that meet broad, objective criteria (e.g., all companies in a certain sector with 25 percent annual earnings growth). The member does not impose limits on the manner in which the research tool searches through a wide universe of securities, nor does it control the generation of the list in order to favor certain securities. For instance, the member does not limit the universe of securities to those in which it makes a market or for which it has made a "buy" recommendation. Similarly, the algorithms for these tools are not programmed to produce lists of securities based on subjective factors that the member has created or developed, nor do the algorithms, for example, produce lists that favor those securities in which the member makes a market or for which the member has made a "buy" recommendation.

- A member allows customers to subscribe to e-mails or other electronic communications that alert customers to news affecting the securities in the customer's portfolio or on the customer's "watch list." Such news might include price changes, notice of pre-scheduled events (such as an imminent bond maturation), or generalized information. The customer selects the scope of the information that the firm will send to him or her.

NASD Regulation generally would view the following communications as falling within the definition of "recommendation":

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[13] Note, however, that hyperlinks conceivably could create suitability obligations, depending, for example, on the information provided to and from the hyperlinked site, the extent to which a member endorses the content of the hyperlinked site, the nature of the firm's relationship to the hyperlinked site, and other attendant facts and circumstances. It should also be noted that NASD Regulation has previously issued guidance regarding the responsibility of members for the content of hyperlinked sites. *See* Letter from Thomas Selman, Vice President, NASD Regulation, Disclosure and Investor Protection to Craig Tyle, General Counsel, Investment Company Institute, Nov. 11, 1997. This letter can be accessed through NASD Regulation's Web Site at *www.nasdr.com /2910/2210_01.htm*. *See also* Use of Electronic Media, *supra* note 6, at 65 Fed. Reg. at 25848-25849, *32-49 (discussing responsibility for hyperlinked information). In addition, NASD Regulation has provided guidance to firms regarding the use of "chat rooms" and "bulletin boards." *See* NtM 96-50, 1996 NASD LEXIS 60 (July 1996).

- A member sends a customer-specific electronic communication (e.g., an e-mail or pop-up screen) to a targeted customer or targeted group of customers encouraging the particular customer(s) to purchase a security.[14]

- A member sends its customers an e-mail stating that customers should be invested in stocks from a particular sector (such as technology) and urges customers to purchase one or more stocks from a list with "buy" recommendations.

- A member provides a portfolio analysis tool that allows a customer to indicate an investment goal and input personalized information such as age, financial condition, and risk tolerance. The member in this instance then sends (or displays to) the customer a list of specific securities the customer could buy or sell to meet the investment goal the customer has indicated.[15]

- A member uses data-mining technology (the electronic collection of information on Web Site users) to analyze a customer's financial or online activity—whether or not known by the customer—and then, based on those observations, sends (or "pushes") specific investment suggestions that the customer purchase or sell a security.

Members should keep in mind that these examples are meant only to provide guidance and are not an exhaustive list of communications that NASD Regulation does or does not consider to be "recommendations." As stated earlier, many other types of electronic communications are not easily characterized. In addition, changes to the factual predicates upon which these examples are based (or the existence of additional factors) could alter the determination of whether similar communications may or may not be viewed as "recommendations." Members, therefore, should analyze all relevant facts and circumstances, bearing in mind the general principles noted earlier and discussed below, to determine whether a communication is a "recommendation," and they should take the necessary steps to fulfill their suitability obligations. Furthermore, these examples are based on technological services

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[14] Note that there are instances where sending a customer an electronic communication that highlights a particular security (or securities) will not be viewed as a "recommendation." For instance, while each case requires an analysis of the particular facts and circumstances, a member generally would not be viewed as making a "recommendation" when, pursuant to a customer's request, it sends the customer (1) electronic "alerts" (such as account activity alerts, market alerts, or price, volume, and earnings alerts) or (2) research announcements (e.g., a firm's "stock of the week") that are not tailored to the individual customer, as long as neither—given their content, context, and manner of presentation—would lead a customer reasonably to believe that the firm is suggesting that the customer take action in response to the communication.

[15] Note, however, that a portfolio analysis tool that merely generates a suggested mix of general classes of financial assets (e.g., 60 percent equities, 20 percent bonds, and 20 percent cash equivalents), without an accompanying list of securities that the customer could purchase to achieve that allocation, would not trigger a suitability obligation. On the other hand, a series of actions which may not constitute "recommendations" when considered individually, may amount to a "recommendation" when considered in the aggregate. For example, a portfolio allocator's suggestion that a customer could alter his or her current mix of investments followed by provision of a list of securities that could be purchased or sold to accomplish the alteration could be a "recommendation." Again, however, the determination of whether a portfolio analysis tool's communication constitutes a "recommendation" will depend on the content, context, and presentation of the communication or series of communications.

that are currently used in the marketplace. They are not intended to direct or limit the future development of delivery methods or products and services provided online.

Guidelines For Evaluating Suitability Obligations

NASD Regulation believes that members should consider, at a minimum, the following guidelines when evaluating their suitability obligations. None of these guidelines is determinative. Each is but one factor to be considered in evaluating all of the facts and circumstances surrounding the communication.

- A member cannot avoid or discharge its suitability obligation through a disclaimer where the particular communication reasonably would be viewed as a "recommendation" given its content, context, and presentation.[16] NASD Regulation, however, encourages members to include on their Web Sites (and in other means of communication with their customers) clear explanations of the use and limitations of tools offered on those sites.

- Members should analyze any communication about a security that reasonably could be viewed as a "call to action" and that they direct or appear to direct to a particular individual or targeted group of individuals—as opposed to statements that are generally made available to all customers or the public at large—to determine whether a "recommendation" is being made.[17]

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[16] Although, as noted previously, a broker/dealer cannot disclaim away its suitability obligation, informing customers that generalized information provided is not based on the customer's particular financial situation or needs may help clarify that the information provided is not meant to be a "recommendation" to the customer. Whether the communication is in fact a "recommendation" would still depend on the content, context, and presentation of the communication. Accordingly, a member that sends a customer or group of customers information about a security might include a statement that the member is not providing the information based on the customers' particular financial situations or needs. Members may properly disclose to customers that the opinions or recommendations expressed in research do not take into account individual investors' circumstances and are not intended to represent "recommendations" by the member of particular stocks to particular customers.

Members, however, should refer to previous guidelines issued by the SEC and NASD that may be relevant to these and/or related topics. For instance, the SEC has issued guidelines regarding whether and under what circumstances third-party information is attributable to an issuer, and the SEC noted that the guidance also may be relevant regarding the responsibilities of broker/dealers. Use of Electronic Media, *supra* note 6, at 65 Fed. Reg. at 25848-25849, *32-49 (discussing entanglement and adoption theories). *See also supra* note 13 and discussion therein.

[17] We note that there are circumstances where the act of sending a communication to a specific group of customers will not necessarily implicate the suitability rule. For instance, a broker/dealer's business decision to provide only certain types of investment information (e.g., research reports) to a category of "premium" customers would not, without more, trigger application of the suitability rule. Conversely, members may incur suitability obligations when they send a communication to a large group of customers urging those customers to invest in a security.

- Members should scrutinize any communication to a customer that suggests the purchase, sale, or exchange of a security—as opposed to simply providing objective data about a security—to determine whether a "recommendation" is being made.[18]

- A member's transmission of unrequested information will not necessarily constitute a "recommendation." However, when a member decides to send a particular customer unrequested information about a security that is not of a generalized or administrative nature (e.g., notification of a stock split or a dividend), the member should carefully review the circumstances under which the information is being provided, the manner in which the information is delivered to the customer, the content of the communication, and the original source of the information. The member should perform this review regardless of whether the decision to send the information is made by a representative employed by the member or by a computer software program used by the member.

- Members should be aware that the degree to which the communication reasonably would influence an investor to trade a particular security or group of securities—either through the context or manner of presentation or the language used in the communication—may be considered in determining whether a "recommendation" is being made to the customer.

NASD Regulation emphasizes that the factors listed above are guidelines that may assist members in complying with the suitability rule. Again, the presence or absence of any of these factors does not by itself control whether a "recommendation" has been made or whether the member has complied with the suitability rule. Such determinations can be made only on a case-by-case basis taking into account all of the relevant facts and circumstances.

Conclusion

The foregoing discussion highlights some suggested guidelines to assist in determining when electronic communications constitute "recommendations," thereby triggering application of the NASD's suitability rule. NASD Regulation acknowledges the numerous benefits that are enjoyed by members and their customers as a result of the Internet and online brokerage services. NASD Regulation emphasizes that it neither takes a position on nor seeks to influence any firm's or customer's choice of a particular business model in this electronic environment. At the same time, however, NASD Regulation urges members both to consider all compliance implications when implementing new services and to remember that customers' best interests must continue to be of paramount importance in any setting, traditional or online.

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[18] As with the other general guidelines discussed in this Policy Statement, the presence of this factor alone does not automatically mean that a "recommendation" has been made. For example, where a customer affirmatively requests to be alerted (by e-mail or pop-up screen) when a security reaches a specific price-point, when a company issues an earnings release, or when an analyst changes his or her recommendation of a particular security, the broker/dealer's decision to send the customer the requested information, without more, would not necessarily trigger a suitability obligation.

As new technologies and/or services evolve, NASD Regulation will continue to provide statements or guidance regarding the application of the suitability rule and other rules.[19] To date, NASD Regulation has worked to resolve various suitability-related issues with federal and state regulators, NASD Regulation's e-Brokerage Committee, the NASD's Legal Advisory Board and Small Firm Advisory Board, NASD Regulation's Standing and District Committees, and the NASD membership. This open dialogue has been beneficial, and NASD Regulation will continue to work with regulators, members of the industry and the public on these and other important issues that arise in the online brokerage environment.

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the Notice to Members. NASD Regulation neither solicited nor received written comments on the Notice to Members. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) **Purpose**

Member firms are increasingly offering online brokerage services to their retail customers. The Internet gives retail customers the tools to manage their own accounts and conduct their own trading activity and the ability to obtain access to an unprecedented amount of information. Online trading offers many benefits to member firms and retail customers, but member firms must continue to fulfill their suitability obligations in the online environment whenever they "recommend" to a customer the purchase, sale, or exchange of a security.

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[19] In this regard, NASD Regulation is considering further discussion of the application of the suitability

The Notice to Members states that the suitability rule (NASD Rule 2310) remains fully applicable to online activities in those cases where a member "recommends" securities transactions to its customers. The Notice to Members does not expand or create any new obligations under the suitability rule, nor does it establish a "bright line" test for determining whether a particular communication constitutes a "recommendation" for purposes of the suitability rule. NASD Regulation instead provides guidance to members through the use of examples of communications that NASD Regulation believes fall within and outside the definition of "recommendation." The Notice to Members also articulates several broad principles that member firms can use in evaluating whether a particular online communication could fall within the definition of "recommendation" for purposes of the suitability rule.

(2) **Statutory Basis**

NASD Regulation believes that the Notice to Members is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that member firms that make "recommendations" to customers in the online environment have an obligation to determine whether the "recommendations" are suitable for such customers. NASD Regulation believes that this Notice to Members is necessary to protect investors and the public interest with respect to online trading.

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rule to electronic communications involving initial public offerings in future guidance.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the Notice to Members will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

The Notice to Members is effective upon filing pursuant to Section 19(b)(3)(A) of the Act and paragraph (f)(1) of Rule 19b-4 thereunder, in that the Notice to Members is a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule. At any time within 60 days of this filing, the Commission may summarily abrogate this proposal if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the Notice to Members that are filed with the Commission, and all written communications relating to the Notice to Members between the Commission and any person, other than those that may be withheld from

the public in accordance with the provisions of 5 U.S.C. §552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR §200.30-3(a)(12).

Jonathan G. Katz
Secretary