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All submissions should refer to File Number SR-CHX-2004-12. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change 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 Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CHX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CHX-2004-12 and should be submitted on or before October 28, 2004.

## V. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5) of the Act.<sup>27</sup>

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>28</sup> that the proposed rule change (SR-CHX-2004-12) and Amendment No. 1 thereto are approved, and that Amendments No. 2 and 3 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>29</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50463; File No. SR-NASD-2003-13]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto, and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to Adopt New Interpretive Material to NASD Rule 2210(d)(2)(N) to Allow NASD Member Firms to Use Certain Investment Analysis Tools

September 28, 2004.

#### I. Introduction

On February 3, 2003, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to adopt a new Interpretive Material ("IM") to NASD Rule 2210(d)(2)(N) that would allow NASD member firms to use investment analysis tools that show the probability that investing in specific securities or mutual funds may produce a desired result. On February 27, 2003, the NASD amended the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for notice and comment in the **Federal Register** on April 3, 2003.<sup>4</sup> The Commission received seven comment letters on the proposal.<sup>5</sup> On December 2, 2003, the NASD responded to the comment letters and amended the proposed rule change.<sup>6</sup> The NASD filed another amendment to make minor changes to the proposed rule change on February 27, 2004.<sup>7</sup> This order approves

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See February 27, 2003, letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, and attachments ("Amendment No. 1"). The original proposed rule change was inadvertently filed without page 5. In Amendment No. 1, NASD removed pages 1-25 of the original filing and replaced them with new pages 1-25. The Commission did not require the NASD to re-file pages 26-230.

<sup>4</sup> See Securities Exchange Act Release No. 47590 (March 28, 2003), 68 FR 16325.

<sup>5</sup> See *infra* note 8 (citing comment letters).

<sup>6</sup> See December 2, 2003, letter from James S. Wrona, Associate General Counsel, NASD, to Katherine A. England, and attachments ("NASD Response Letter" or "Amendment No. 2"). See also *infra* Section III (discussing the NASD's response to comments and amendments to the proposed IM).

<sup>7</sup> See February 26, 2004, letter from James S. Wrona to Katherine A. England, and attachments ("Amendment No. 3"). In Amendment No. 3, the

the proposed rule change as modified by Amendment No. 1. Simultaneously, the Commission provides notice of filing of Amendment Nos. 2 and 3 and grants accelerated approval of Amendment Nos. 2 and 3. The complete text of the proposed rule change, as approved, is attached as Exhibit A.

#### II. Summary of Comments

The Commission received seven comment letters on the NASD's proposed rule change as modified by Amendment No. 1.<sup>8</sup> One comment letter supported the NASD's rule change as originally proposed, five supported the proposed rule change but suggested certain modifications, and one opposed the proposed rule change.<sup>9</sup> The following summary of comments provides an overview of the commenters' concerns:

- *NASD Should Revise the Definition of Investment Analysis Tools*

Several commenters suggested that the NASD revise its definition of investment analysis tools.<sup>10</sup> One commenter expressed concern that the proposed definition of investment analysis tools does not clearly reflect the "distinction between tools that show a probability that investing in *specific* securities or mutual funds will produce

NASD made changes to the format of the proposed rule language, and added specific references to NASD and Commission rules and requirements.

<sup>8</sup> See the following letters to Jonathan G. Katz, Secretary, SEC: April 24, 2003, letter from Alexander C. Gavis, Associate General Counsel, Fidelity Investments ("Fidelity Letter"); April 24, 2003, letter from Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute ("ICI Letter"); April 24, 2003, letter from Michael J. Hogan, Harris Investor Services LLC ("Harris Letter"); April 29, 2003, letter from Christopher P. Gilkerson, Vice President and Associate General Counsel, Office of Corporate Counsel, Charles Schwab & Co. ("Schwab Letter"); May 1, 2003, letter from Scott W. Campbell, Executive Vice President and General Counsel, Financial Engines, Inc. ("FE Letter"); May 7, 2003, letter from Eliot Wagner, Chair, Technology & Regulation Committee, and Hardy Callcott, Chair, Online Brokerage Legal Committee, Securities Industry Association ("SIA Letter"); and May 9, 2003, letter from John M. Ramsay, Senior Vice President and Regulatory Counsel, The Bond Market Association ("BMA Letter").

<sup>9</sup> The FE Letter expressed approval of the proposed rule change (asserting the proposed rule change "will benefit investors and enhance competition in the securities industry"). FE Letter at 1. The Fidelity, ICI, Schwab, SIA, and BMA Letters expressed approval of the proposed rule change with modifications. The Harris Letter opposed the proposed rule change.

<sup>10</sup> Fidelity Letter at 3; Schwab Letter at 2-4; SIA Letter at 4; BMA Letter at 2-4, 6; Harris Letter at 13. Amendment No. 1 defined an investment analysis tool as "an interactive technological tool that produces simulations and statistical analyses that present a range of probabilities that various investment outcomes might occur, thereby serving as an additional resource to investors in the evaluation of the potential risks of and returns on particular investments." Amendment No. 1 at 3.

<sup>27</sup> 15 U.S.C. 78f(b)(5).

<sup>28</sup> 15 U.S.C. 78s(b)(2).

<sup>29</sup> 17 CFR 200.30-3(a)(12).

a desired result and tools that show probabilities as to how classes of financial assets or style of investing might perform” (emphasis in original).<sup>11</sup> Other commenters suggested that the NASD revise the definition to allow for tools that present a single probability of achieving a desired result, rather than limiting the definition to tools that provide a range of probabilities.<sup>12</sup> These commenters believed that the presentation of a single probability of achieving a desired result can be achieved in a fair and balanced manner through the use of disclosure and/or tool functionality.<sup>13</sup>

One commenter further suggested that the NASD’s proposed definition of investment analysis tools should be revised so that it fully reflects the purpose of the IM and explains “which tools are not covered by the IM’s prescriptive text and therefore are already permissible under existing [NASD] Rule 2210(d). \* \* \*”<sup>14</sup> The commenter argued that, since several of the proposed investment analysis tool disclosure requirements “only make sense if the tool results in or analyzes investment recommendations,” investment analysis tools that analyze a self-directed client’s portfolio in light of a goal provided by the client, such as retirement, and do not make any investment recommendations should be excluded from the proposed definition of investment analysis tools.<sup>15</sup> Additionally, the commenter recommended that investment analysis tools that registered representatives currently use internally to make recommendations to clients (where the tool is not client-facing) also should be excluded from the NASD’s proposed definition of investment analysis tools.<sup>16</sup> The commenter offered a revised definition of investment analysis tools, stating that the failure to amend the NASD’s proposed definition

“will lead to confusion and inconsistency between past and current interpretations and practices under different parts of [NASD] Rule 2210(d).”<sup>17</sup>

One commenter suggested that investment analysis tools provided exclusively to institutional investors should be excluded from the scope of the proposed IM’s prohibition,<sup>18</sup> while another commenter encouraged the NASD to revise the definition of investment analysis tools to clarify that the IM does not apply to bond calculators or risk management tools used by money managers and institutional investors to help manage portfolios.<sup>19</sup> One commenter opined that the definition is “unnecessarily broad and confusing” and argued that the NASD tried to clarify that “certain ‘automated educational’ [t]ools that present certain ‘portfolio analysis’ financial planning may not be subject to the rule, but it appears that portfolio-based planning [t]ools that are more than ‘educational’ would be subject to the rule.”<sup>20</sup>

• *NASD Should Clarify the Requirement That Investment Analysis Tools Use a Mathematical Process That Can Be Audited and Reviewed*

Several commenters suggested that the NASD further explain its intent with regard to the requirement that investment analysis tools use a mathematical process that can be audited and reviewed.<sup>21</sup> The commenters expressed concern that this requirement could be interpreted to require member firms to obtain third-party audits of investment analysis tools.<sup>22</sup> Two commenters urged the NASD to clarify that it does not intend for members to collect and maintain an archive of calculations of each session during which an investment analysis tool is used.<sup>23</sup> One commenter noted that some broker-dealers may purchase their investment analysis tools from third party vendors who may not be willing to waive confidentiality provisions in licensing agreements with respect to granting the broker-dealer

access to the mathematical processes of the investment analysis tools.<sup>24</sup>

• *NASD Should Modify the Requirement to Disclose the Universe of Investments Considered*

Some commenters suggested that the NASD modify its disclosure requirements to eliminate unnecessary and duplicative disclosure. For example, several commenters opposed the requirement of a disclosure statement explaining that there are other investments that were not considered by the investment analysis tool that may have characteristics similar or superior to those analyzed by the tool.<sup>25</sup> One of those commenters suggested that the requirement be revised to require disclosure only of a description of the universe of investments considered in the analysis, reasoning that investors “would likely be confused by boilerplate disclosure stating that other similar investments were not considered.”<sup>26</sup> One commenter argued that by requiring disclosure of the universe of investments considered in the analysis, investors would know that not all investments offered anywhere were considered.<sup>27</sup>

• *NASD Should Modify the Proposed Disclosure Requirements*

The NASD’s proposed disclosure requirements apply not only to investment analysis tools, but also to written reports indicating the results generated by the use of investment analysis tools, and any related sales material. Commenters had varying concerns about this aspect of the proposal. For example, one commenter advocated an alternative approach in which the NASD would grant member firms the discretion to determine the best approach regarding disclosure between investment analysis tools and the reports generated by use of the tools, rather than requiring that all written reports contain the same disclosure, which would be redundant and unhelpful.<sup>28</sup> The commenter also suggested that the disclosure requirements not be applied broadly to all tool-related sales material, but rather be limited to sales material containing a

<sup>11</sup> Fidelity Letter at 3. Though the commenter noted that the distinction is indicated in the IM’s first footnote, the commenter recommended that the distinction be recognized in the text of the definition. *Id.*

<sup>12</sup> *Id.* at 4; Schwab Letter at 4 (“\* \* \* there are tools whose purpose and use do not include presenting a range of probabilities.”); SIA Letter at 3.

<sup>13</sup> See e.g., Fidelity Letter at 4.

<sup>14</sup> Schwab Letter at 2.

<sup>15</sup> *Id.* at 2–3. See also SIA Letter at 4 (investment analysis tools that include yield or performance information as part of an analysis of a client’s portfolio in light of client-supplied goals should be excluded).

<sup>16</sup> Schwab Letter at 3. See also SIA Letter at 4 (arguing that investment analysis tools used internally by registered representatives or investment advisers in the course of preparing advice for clients should be excluded from the scope of the IM’s prohibition).

<sup>17</sup> Schwab Letter at 3.

<sup>18</sup> SIA Letter at 4.

<sup>19</sup> BMA Letter at 6.

<sup>20</sup> Harris Letter at 13.

<sup>21</sup> ICI Letter at 3; Fidelity Letter at 5; Harris Letter at 14.

<sup>22</sup> Fidelity Letter at 5; ICI Letter at 3.

<sup>23</sup> Schwab Letter at 4 (“The final IM should make clear that it is only the general mathematical process itself that must be documented and not the specific calculations generated for any specific application of the tool.”); Harris Letter at 14 (“No guidance is provided as to how a member firm must audit the [t]ool, what features are subject to an audit requirement or whether it applies on a per client basis.”)

<sup>24</sup> Harris Letter at 14.

<sup>25</sup> ICI Letter at 3; Harris Letter at 15; Fidelity Letter at 5–6.

<sup>26</sup> Fidelity Letter at 6 (“... [t]his would give [investors] the impression that the ‘grass may be greener’ with other investments, but would fail to provide the investor with any meaningful analysis.”)

<sup>27</sup> ICI Letter at 3.

<sup>28</sup> Fidelity Letter at 6. Rather, the commenter recommended that firms be required to rationalize disclosure between the tool and the reports, and opined of a greater likelihood that investors would read the disclosure information if firms are given discretion in this area. *Id.*

detailed description of the tools as well as investor-specific probability presentations.<sup>29</sup> Similarly, another commenter suggested that, rather than requiring the member firm to make the same disclosure in all reports and sales material, “the member could determine where disclosure of this information would be most appropriate, so long as the totality of the disclosure provided to the investor includes all elements of disclosure required by the IM.”<sup>30</sup>

One commenter argued against the NASD’s proposal to apply the disclosure requirements broadly to all investment analysis tool-related sales material, and recommended that the disclosure requirements apply only to “sales material that contains either a detailed description of the tool or investor-specific probability presentations.”<sup>31</sup> Without this constraint on the scope of the disclosure requirement, the commenter believed that all pieces of sales material might fall within the scope of the proposed rule, and therefore be required to comply with the substantive and disclosure requirements outlined in IM-2210-(c) and (d). For both written reports and sales material, the commenter recommended that the NASD allow member firms the flexibility to self-determine the appropriate disclosure for reports and sales material.<sup>32</sup>

One commenter suggested that the NASD allow members to have discretion over where to place the required clear and prominent disclosures “as part of the tool’s interactive process and/or on any report that provides the tool’s result.”<sup>33</sup> The commenter encouraged the NASD to modify the proposed rule to expressly permit both written and electronic disclosures, “given that this is a rule about electronic investment analysis tools.”<sup>34</sup> In a general criticism of the disclosure provision, one commenter suggested that, for most investment analysis tools, the NASD’s mandated conditions and disclosures “are unnecessary either because the presentation, purpose or level of detail of the [t]ool is self evident, or the [t]ool itself contains sufficient context and disclosure without the additional NASD requirements.”<sup>35</sup>

• *NASD Should Modify or Eliminate the 30-Day Pre-Filing and Approval Requirement*

Most of the commenters opposed the NASD’s proposed requirement that member firms provide the NASD with access to a proposed investment analysis tool at least 30 days prior to its first use, and the required filing of any templates for written reports produced by, or sales material concerning, the tool.<sup>36</sup> One commenter believed that the pre-use access and filing requirement “places broker-dealers at a competitive disadvantage given that investment advisers, mutual funds, and unregulated financial portals on the Web have no such pre-use approval process for their investment analysis tools.”<sup>37</sup> Another commenter opposed the pre-filing requirement by arguing that it “would result in significant delays in the launch of investment tools to investors.”<sup>38</sup> Noting that investment analysis tools can take from as little as a few months to over a year or more to develop, the commenter remarked that the pre-use access and filing requirement would essentially insert the NASD into the development cycle of investment analysis tools, likely at the final stages of the process. The commenter argued that this “will result in member firms devoting a significant amount of time to negotiating comments with the NASD at the last stages of development, detracting from focus on launching the tool with the public.”<sup>39</sup> Noting that the NASD does not consider the approval requirement to be a merit based review, and will instead only review an investment analysis tool to confirm that the requisite disclosures have been made, the commenter argued against the need for a 30-day pre-filing and approval requirement.<sup>40</sup> The commenter suggested that the NASD conduct its review either “in due course or after a member has first used the tool,” reasoning that “the proposed review would be an inefficient extension of the NASD staff’s responsibilities, particularly when the staff is not charged with responsibility of pre-screening other types of investment tools.”<sup>41</sup> Another commenter remarked that “the disclosure requirements, as modified, would be clear enough on their face for members to implement, rendering any prior review unnecessary.”<sup>42</sup>

One commenter recommended reducing the 30-day period to a 10-day

period.<sup>43</sup> Noting that no other provisions of NASD Rule 2210, nor any other interpretive material issued under the rule, require the filing of information with the NASD more than 10 days before use, the commenter remarked that a 10-day pre-filing and approval requirement “will facilitate the ability of members to utilize their current internal procedures relating to the review and filing of advertising and sales literature in connection with the use of these tools.”<sup>44</sup>

• *NASD Should Clarify Which Regulatory Regime Applies to the Use of Investment Analysis Tools*

A few commenters expressed concern that the NASD’s proposed IM does not resolve ambiguity regarding which regulatory scheme applies to the use of investment analysis tools.<sup>45</sup> Specifically, one commenter questioned the uncertainty of whether “the rule prohibiting predictions and projections, the existing exception to this rule for hypothetical illustrations of mathematical principles, the exception to this rule for tools as proposed in the IM, or the rule permitting forecasts that are not unwarranted and have a reasonable basis” applies to the use of investment analysis tools.<sup>46</sup> The same commenter alleged that the proposed IM took a “broader historical interpretation” of the scope of the NASD Rule 2210(d)(2)(N) prohibition as applied to investment analysis tools, and suggested that the language “be revised to avoid upsetting settled expectations.”<sup>47</sup> The commenter noted that many broker-dealers consider their investment analysis tools to fall under the exception to the general prohibition of Rule 2210(d)(2)(N) that permits hypothetical illustrations of mathematical principles.<sup>48</sup>

Similarly, one commenter recommended that the NASD explain in more detail the difference between a permissible “forecast” and a prohibited “projection or prediction” and suggested that the IM is inconsistent

<sup>29</sup> *Id.* at 7–8.

<sup>30</sup> ICI Letter at 4. *See also* SIA Letter at 4 (recommending flexibility in provisions for disclosure and presentation of information).

<sup>31</sup> Fidelity Letter at 6–7.

<sup>32</sup> *Id.*

<sup>33</sup> Schwab Letter at 4.

<sup>34</sup> *Id.*

<sup>35</sup> Harris Letter at 14.

<sup>36</sup> Schwab Letter at 5; Fidelity Letter at 7; Harris Letter at 16–18; ICI Letter at 4; SIA Letter at 4.

<sup>37</sup> Schwab Letter at 5.

<sup>38</sup> Fidelity Letter at 7.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> Schwab Letter at 6.

<sup>43</sup> ICI Letter at 4.

<sup>44</sup> *Id.* Additionally, the commenter recommended that the filing, approval, and recordkeeping requirements under NASD Rule 2210 not apply to amendments to a tool, related sales material, or written reports indicating the tool’s results that are either non-substantive or merely updates to preexisting templates that the NASD previously approved. *Id.* at 4–5.

<sup>45</sup> SIA Letter at 2; Harris Letter at 4–19.

<sup>46</sup> SIA Letter at 2.

<sup>47</sup> *Id.* at 4. The SIA Letter recommended that the IM should be revised to describe the NASD’s prior application of the prohibition as applying to “communications (generated by a tool or otherwise) that unfairly implied a specific result, included exaggerated or unwarranted claims or contained misrepresentations.” *Id.* at 5.

<sup>48</sup> *Id.* at 3.

with prior NASD staff interpretations, which the commenter interpreted as having previously authorized the use of investment analysis tools, and takes an unprecedented and overly expansive interpretation of Rule 2110(d)(2)(N).<sup>49</sup> The same commenter recommended that the NASD withdraw the proposed IM and instead work to harmonize what the commenter characterized as inconsistencies within NASD rules and between NASD and NYSE rules with respect to the terms “forecast,” “projection” and “prediction,” where all three terms are, in the commenter’s opinion, sometimes used interchangeably.<sup>50</sup> The commenter opined that investment analysis tools should be treated as “permissible forecasts” under existing interpretations of Rule 2110(d)(2)(N) and suggested that current NASD rules against exaggerated or unwarranted claims or misrepresentations already provide adequate safeguards for the public.<sup>51</sup>

• *NASD Should Clarify the Applicability of the IM to Entities Dually Registered as Investment Advisers*

Two commenters requested the NASD to clarify whether a broker-dealer that also is registered as an investment adviser would be subject to the provisions of the IM when offering public customers an investment analysis tool in its capacity as an investment adviser.<sup>52</sup> One commenter suggested that since investment analysis tools offered by registered investment advisers are already subject to regulation and oversight under the regulatory regime applicable to registered investment advisers, such tools should not be subject to an additional layer of regulation under the NASD IM when offered through a broker-dealer to its customers or through a united Web site of a broker-dealer dually-registered as an adviser.<sup>53</sup> Similarly, the same commenter requested the NASD to clarify the applicability of the IM to investment analysis tools offered by affiliates of a broker-dealer, as well as non-affiliates and other third parties, including instances where a broker-dealer’s Web site links to such other party’s investment analysis tool.<sup>54</sup>

• *Undue Burden on Competition*

Some commenters objected to what they believe is a potential burden on competition that could result from the proposed IM, in particular the pre-filing

and approval process.<sup>55</sup> The commenters were concerned that the IM could affect the ability of NASD-member firms to compete with investment advisers, banks, financial planners, financial Web sites, non-NASD broker-dealers and other non-regulated entities that would not be subject to the pre-use filing and approval process with respect to investment analysis tools.

One commenter stated that member firms linking customers to an investment adviser, bank, or other affiliated or non-affiliated third party offering an investment analysis tool may or may not be subject to the rule, the uncertainty of which the commenter believes creates competitive disadvantages for certain classes of member firms depending on their organizational structure and relationships with third parties.<sup>56</sup> Another commenter suggested that the pre-review process could inhibit the incentive of NASD-member firms to develop proprietary products tailored to the needs of their customers and favor third-party vendors who would not be subject to the rule.<sup>57</sup>

### III. The NASD’s Response to Comments

The NASD filed Amendment No. 2 on December 3, 2003, which responded to the comments and elaborated on the NASD’s rationale for the proposed IM. Amendment No. 2 modified the NASD’s proposal to accommodate many of the commenters’ concerns.<sup>58</sup> The NASD’s responses to several of the more significant issues are addressed below.

One of the NASD’s modifications to the proposed rule was a further delineation of the types of communications generally prohibited by the proposed IM. In Amendment No. 2, the NASD modified the proposed IM to make it consistent with the recently amended language of NASD Rule 2210(d)(1)(D), formerly NASD Rule 2210(d)(2)(N), by clarifying that the proposed rule change “prohibits predictions and projections involving the likely performance of both specific securities and investment strategies and styles” (emphasis in original).<sup>59</sup> Noting

<sup>55</sup> See, e.g., Schwab Letter at 5; Harris Letter at 4. But see FE Letter at 3–5 (asserting that the proposed IM will level the playing field among investment advisers, broker-dealers and other financial institutions, increase competition, foster innovation, and benefit investors).

<sup>56</sup> Harris Letter at 4–5.

<sup>57</sup> BMA Letter at 5.

<sup>58</sup> See NASD Response Letter, *supra* note 6.

<sup>59</sup> *Id.* at 2. The initial version of the proposed IM “focused on projections of specific securities and did not indicate that [NASD] Rule 2210(d)(1)(D) also applied to predictions and projections involving investment strategies and styles.” *Id.* An

that the dividing line between predictions of specific investments and investment strategies “is problematic and no meaningful distinction can be made from the perspective of investor protection,” the NASD broadened the scope of the proposed IM by expanding the definition of investment analysis tools to allow members to use or offer tools that present “the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken,” as long as the member complies with the proposed IM’s requirements.<sup>60</sup>

In response to commenters’ concerns with the pre-filing requirement, the NASD modified the proposed IM to eliminate the 30-day pre-filing requirement and instead require members to file their investment analysis tools with the NASD Advertising Regulation Department within 10 days after first use. The NASD recognized commenters’ concerns with respect to the NASD interfering in the development of investment analysis tools and acknowledged that the pre-filing requirement is unnecessary in light of the fact that the NASD staff will not be conducting a merit review of the tools.<sup>61</sup> Further, the NASD modified the proposed IM to exempt from the 10-day post-use access and filing requirement members that provide investment analysis tools exclusively to institutional customers. Such members would, however, remain subject to the disclosure requirements and would retain their suitability obligations.<sup>62</sup> The NASD further modified the proposed IM to require members to provide the NASD with access to investment analysis tools or re-file with the NASD the written-report templates or sales materials only if firms make a material change to the investment analysis tools,

exception to NASD Rule 2210(d)(1)(D) permits a hypothetical illustration of mathematical principals, provided that it does not predict or project the performance of an investment or investment strategy. See Securities Exchange Act Release No. 47820 (May 9, 2003) (SR-NASD-2000-12), 68 FR 27116, 27123 (May 19, 2003) (adopting amended NASD Rule 2210).

<sup>60</sup> NASD Response Letter, *supra* note 6, at 2–3 (emphasis in original). The revised definition states that an investment analysis tool is “an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices.” Amendment No. 3, *supra* note 7, at 2–3.

<sup>61</sup> NASD Response Letter, *supra* note 6, at 3.

<sup>62</sup> *Id.*

<sup>49</sup> Harris Letter at 7–8.

<sup>50</sup> *Id.* at 6.

<sup>51</sup> *Id.* at 5.

<sup>52</sup> FE Letter at 4 (n. 14); Harris Letter at 11–12).

<sup>53</sup> Harris Letter at 11–12.

<sup>54</sup> *Id.* at 3, 12.

written-report templates, or sales materials.<sup>63</sup>

The NASD also responded to commenters' concerns regarding the permissibility of calculating a single probability score by amending the proposed IM to eliminate the requirement that investment analysis tools present a range of probabilities, including upside, downside, and median projections.<sup>64</sup> The NASD recognized that the removal of this requirement would simplify the proposed IM by eliminating a provision that did not particularly contribute to the goals of investor protection.<sup>65</sup>

Similarly, the NASD eliminated the requirement that investment analysis tools use a mathematical process that can be audited and reviewed. The NASD recognized the difficulty inherent in requiring NASD examiners to review the mathematical processes of investment analysis tools for compliance with the proposed IM. Further, the NASD eliminated the requirement in order to avoid any perception that may have led the investing public to believe that the NASD would be performing a merit-based review of these investment analysis tools.<sup>66</sup>

The NASD also responded to a suggestion that the NASD standard be harmonized with New York Stock Exchange Rule 472 that permits forecasts that are clearly labeled as such and are not exaggerated or unwarranted.<sup>67</sup> The NASD explained that "forecasts" relate to estimates of economic performance and results, which is different from predicting or projecting how a particular investment or investing style might perform.<sup>68</sup> Accordingly, the NASD affirmed its belief in requiring member firms to provide the information specified in the streamlined disclosure requirements of the amended IM when offering investment analysis tools, in addition to requiring that the tools not produce misleading, exaggerated, or unwarranted claims.<sup>69</sup>

With regard to commenters who stated their belief that investment analysis tools are already permitted by the exception to NASD Rule 2210(d)(2)(N) permitting hypothetical illustrations of mathematical principles, the NASD explained that amended NASD Rule 2210(d)(1)(D), formerly

NASD Rule 2210(d)(2)(N), operates generally to prohibit investment analysis tools, as they make predictions and projections which are prohibited by the rule.<sup>70</sup> Rather, the hypothetical illustration exception applies to "tools that serve the functions of a calculator that computes the mathematical outcome of certain assumed variables without predicting the likelihood of either the assumed variables or the outcome."<sup>71</sup>

#### IV. Discussion and Commission Findings

The Commission has reviewed carefully the proposed rule change, the comment letters, and the NASD's response to the comments, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association<sup>72</sup> and, in particular, the requirements of section 15A(b)(6) of the Act,<sup>73</sup> which requires, among other things, that the NASD's rules 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.

In particular, the Commission notes that, in response to commenters' concerns, the NASD modified the proposed IM to eliminate the 30-day pre-filing requirement in favor of a 10-day post-use access and filing requirement. Additionally, the filing requirement is waived for investment analysis tools provided exclusively to institutional investors, though the Commission notes that such tools would still be subject to the disclosure requirements of the proposed IM. The Commission believes this modification of the proposed IM addresses the commenters' concerns and that the amended provision is reasonable. Since the NASD will not be performing substantive merit reviews of these tools, however, the Commission reminds NASD member firms of the need to take great care in providing complete and understandable disclosure to minimize

the potential for any investment analysis tool literature or output to be presented in a misleading manner.<sup>74</sup>

With respect to the disclosure regarding the universe of investments considered by investment analysis tools, the Commission agrees that the NASD's approach is reasonably tailored to provide meaningful disclosure regarding the securities considered by the tools and the limitations inherent in the scope of any analysis provided. Regarding commenters' concerns about the requirement that investment analysis tools use a mathematical process that can be audited, the Commission notes that the NASD has dropped this provision from the proposed IM. The Commission believes that this modification to the proposed IM is reasonable. While the Commission acknowledges that the NASD's modification was intended, in part, to alleviate the commenters' concerns that the NASD intended for members to collect and maintain an archive of calculations performed by the tools, or to perhaps require third-party audits of the tools, the Commission reminds NASD members that any investment analysis tools purporting to employ mathematical principles while accounting for certain variables and assumptions should, by their nature, be capable of being audited with respect to the processes employed and functions performed by the tools.

Similarly, the Commission notes that the NASD has amended the proposed IM to remove the requirement that investment analysis tools present a range of probabilities, thereby allowing tools to present a single probability of achieving a desired result. While the Commission believes this modification is reasonable, the Commission reminds broker-dealers of the importance of meaningful and readily-understandable disclosure for any investment analysis tools that present the likelihood of achieving a single result in such a way that guards against the potential for misleading the investing public.

<sup>70</sup> See Securities Exchange Act Release No. 47820 (May 9, 2003) (SR-NASD-2000-12), 68 FR 27116, 27125 (May 19, 2003) (noting that the rule permits a member to present a hypothetical illustration of mathematical principles (e.g., a mutual fund cost calculator), but would not permit the illustration to predict or project the performance of an investment or investment strategy, since making a prediction based on those calculations could be misleading to investors).

<sup>71</sup> NASD Response Letter at 5.

<sup>72</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>73</sup> 15 U.S.C. 78o-3(b)(6).

<sup>74</sup> The Commission notes that NASD member firms should be particularly mindful when an investment analysis tool or any report or sales material derived from such a tool is used in any way that could be construed as promoting the future performance of one or more specific investment companies. Tools, reports, or sales materials that are used in this manner may raise issues under the antifraud provisions of the federal securities laws and implicate the investment company advertising rules. See, e.g., 17 CFR 230.156(b)(2) (Rule 156(b)(2) under the Securities Act of 1933 provides that representations about future investment performance could be misleading under certain circumstances including situations where representations are made as to possible future gains or income.).

<sup>63</sup> *Id.* at 4.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 5.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

In response to one commenter's concerns regarding broker-dealers dually registered as investment advisers, the Commission notes that the proposed IM applies only to NASD members. Further, with respect to the obligations of a broker-dealer for hyperlinked information, the Commission reminds NASD members of the Commission's guidance regarding the applicable theories of liability for hyperlinked information.<sup>75</sup>

The Commission does not believe that the proposed IM will place any undue burden on competition. The Commission notes the elimination of the pre-use filing requirement from the proposed IM and, though financial advisers and other entities may not be subject to the IM since the NASD's jurisdiction only extends to its member broker-dealers, the Commission feels that the amended IM is narrowly tailored to prevent fraudulent practices and protect the investing public without unduly restricting or burdening the competitive market for these types of products with respect to NASD members.

With regard to all other issues raised by the commenters, the Commission is satisfied that the NASD has adequately addressed the commenters' concerns.

The Commission expects that the NASD will carefully monitor compliance with the provisions of the IM among its member broker-dealers offering investment analysis tools and, in particular, will review the required disclosures, including the nature of the tools' output, with an eye towards preventing misleading and fraudulent statements and protecting the investing public.

The Commission finds good cause for approving Amendment Nos. 2 and 3 before the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The NASD filed Amendment No. 2 in response to comments it received after the publication of the notice of filing of the proposed rule change, to address certain commenters' concerns and to amend the proposed IM. In addition, the NASD filed Amendment No. 3 to make minor modifications to the proposed rule change, including formatting changes and adding references to NASD and Commission rules and requirements. Because Amendment No. 2 is responsive to the commenters' concerns and Amendment No. 3 is responsive to the Commission's suggested

modifications, and because neither Amendment presents any novel issues, the Commission finds good cause for accelerating approval of Amendment Nos. 2 and 3.

#### V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment Nos. 2 and 3 are consistent with the Act. Comments may be submitted by any of the following methods:

##### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2003-13 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File No. SR-NASD-2003-13. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change 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 the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to file number SR-NASD-2003-13 and should be submitted on or before October 28, 2004.

#### VI. Conclusion

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>76</sup> that the proposed rule change (SR-NASD-2003-13), as amended by Amendment No. 1, be, and it hereby is, approved, and that Amendment Nos. 2 and 3 to the proposed rule change be, and hereby are, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>77</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

##### **Exhibit A**

\* \* \* \* \*

##### **Proposed IM-2210-6—Investment Analysis Tools**

\* \* \* \* \*

##### **IM-2210-6. Requirements for the Use of Investment Analysis Tools**

###### *(a) General Considerations*

This Interpretive Material provides a limited exception to NASD Rule 2210(d)(1)(D).<sup>1</sup> No member may imply that NASD endorses or approves the use of any investment analysis tool or any recommendation based on such a tool. A member that offers or intends to offer an investment analysis tool under this Interpretive Material (whether customers use the member's tool independently or with assistance from the member) must, within 10 days of first use, (1) provide NASD's Advertising Regulation Department (Department) access to the investment analysis tool and (2) file with the Department any template for written reports produced by, or sales material concerning, the tool.<sup>2</sup> The member also must provide any supplemental information requested by the Department. The Department may require that the member modify the investment analysis tool, written-report template or sales material. The Department also may require that the

<sup>76</sup> 15 U.S.C. 78s(b)(2).

<sup>77</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> NASD Rule 2210(d)(1)(D) states that "[c]ommunications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." This Interpretive Material allows member firms to offer investment analysis tools (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tools and related sales material in certain circumstances.

Rule 2210(d)(1)(D) does not prohibit, and this Interpretive Material does not apply to, hypothetical illustrations of mathematical principles that do not predict or project the performance of an investment or investment strategy.

<sup>2</sup> After the Department has reviewed the investment analysis tool, written-report template or sales material, a member must notify the Department and provide additional access to the tool and re-file any template or sales material if it makes a material change to the presentation of information or disclosures as required by paragraphs (c) and (d).

<sup>75</sup> See Securities Exchange Act Release No. 42728 (April 28, 2000), 65 FR 25843 (May 4, 2000) (regarding the entanglement and adopting theories of liability for hyperlinked information).

member not offer or continue to offer or use the tool, written-report template or sales material until all changes specified by the Department have been made by the member.

A member that offers an investment analysis tool exclusively to "institutional investors," as defined in Rule 2211(a)(3), is not subject to the post-use access and filing requirement in this paragraph if the communications relating to or produced by the tool meet the criteria for "institutional sales material," as defined in Rule 2211(a)(2). A member that intends to make the tool available to, or that intends to use the tool with, any person other than an institutional investor (such as an employee benefit plan participant or a retail broker-dealer customer) will be subject to the filing and access requirements, however.

As in all cases, a member's compliance with this Interpretive Material does not mean that the member is acting in conformity with other applicable laws and rules. A member that offers an investment analysis tool under this Interpretive Material (whether customers use the member's tool independently or with assistance from the member) is responsible for ensuring that use of the investment analysis tool and all recommendations based on the investment analysis tool (whether made via the automated tool or a written report) comply, as applicable, with NASD's suitability rule (Rule 2310), the other provisions of Rule 2210 (including, but not limited to, the principles of fair dealing and good faith, the prohibition on exaggerated, unwarranted or misleading statements or claims, and any other applicable filing requirements for advertisements and sales literature), the federal securities laws (including, but not limited to, the antifraud provisions), the Securities and Exchange Commission rules (including, but not limited to, SEC Rule 156 under the Securities Act of 1933) and other NASD rules.

#### (b) Definition

For purposes of this Interpretive Material and any interpretation thereof, an "investment analysis tool" is an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices.

#### (c) Use of Investment Analysis Tools and Related Written Reports and Sales Material

A member may provide an investment analysis tool (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tool and related sales material<sup>3</sup> only if:

<sup>3</sup> Sales material that contains an incidental reference to an investment analysis tool (e.g., a brochure that merely mentions a member's tool as one of the services offered by the member) need not include the disclosures required by this Interpretive Material and would not need to be filed with the Department, unless otherwise required by the other provisions of Rule 2210.

(1) The member describes the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;

(2) the member explains that results may vary with each use and over time;

(3) if applicable, the member describes the universe of investments considered in the analysis, explains how the tool determines which securities to select, discloses if the tool favors certain securities and, if so, explains the reason for the selectivity,<sup>4</sup> and states that other investments not considered may have characteristics similar or superior to those being analyzed; and

(4) the member displays the following additional disclosure: "IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results."

#### (d) Disclosures

The disclosures and other required information discussed in paragraph (c) must be clear and prominent and must be in written or electronic narrative form.

\* \* \* \* \*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50473; File No. SR-PCX-2003-64]

### Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendments No. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 3, 4, and 5 Thereto Regarding Facilitation Crossing Procedures

September 29, 2004.

#### I. Introduction

On November 20, 2003, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities

<sup>4</sup> This disclosure must indicate, among other things, whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered based on revenue received by the member in connection with the sale of those securities or based on relationships or understandings between the member and the entity that created the investment analysis tool. The disclosure also must indicate whether the investment analysis tool is limited to searching, analyzing or in any way favoring securities in which the member makes a market or has any other direct or indirect interest. Members are not required to provide a "negative" disclosure (i.e., a disclosure indicating that the tool does not favor certain securities).

Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to modify the Exchange's facilitation crossing procedures in several respects. On July 7, 2004, and July 15, 2004, respectively, the Exchange filed Amendments No. 1 and 2 to the proposed rule change.<sup>3</sup> The proposed rule change as amended by Amendments No. 1 and 2 was published for comment in the **Federal Register** on July 29, 2004.<sup>4</sup> The Commission received no comments on the proposal, as amended. On September 24, 2004, the Exchange submitted Amendment No. 3 to the proposal.<sup>5</sup> On September 29, 2004, the Exchange submitted Amendment No. 4 and Amendment No. 5 to the proposed rule change.<sup>6</sup> This order approves the proposed rule change and Amendments No. 1 and 2, grants accelerated approval of Amendments No. 3, 4, and 5, and solicits comments on Amendments No. 3 and 5.

#### II. Discussion of the Proposed Rule Change

Current PCX Rule 6.47(b), concerning the crossing of facilitation orders, permits a Floor Broker who holds an order for a customer and an order for the proprietary account of an OTP (Options Trading Permit) Holder or OTP Firm

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letters from Mai S. Shiver, Acting Director/Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated July 6, 2004, and July 14, 2004.

<sup>4</sup> See Securities Exchange Act Release No. 50064 (July 22, 2004), 69 FR 45360 ("Notice").

<sup>5</sup> See letter from Mai S. Shiver, Director/Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division, Commission, dated September 23, 2004 ("Amendment No. 3"). In Amendment No. 3, the Exchange expanded the types of orders eligible for crossing with a Customer Order to include orders for the proprietary account of an organization under common control with a Market Maker that is representing the customer. The version of this provision published in the Notice applied only to orders for the proprietary account of an organization under common control with a Lead Market Maker ("LMM") that is representing the customer. Amendment No. 3 also clarified the rule with respect to allocation of the portion of the Customer Order remaining after the Floor Broker executes its guarantee in certain situations, and made technical and stylistic changes to the rule text.

<sup>6</sup> See letters from Mai S. Shiver, Director/Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division, Commission, dated September 28, 2004 ("Amendment No. 4") and September 29, 2004 ("Amendment No. 5"). Amendment No. 4 was a technical amendment correcting typographical errors in the proposed rule text, and is not required to be noticed for comment. In Amendment No. 5, the Exchange proposed to make the effective date of the proposal October 29, 2004 in order to allow the Exchange to provide proper notice and education to the Exchange OTP Holders and OTP Firms that are affected by the rule change.