

MEMO# 16122

May 28, 2003

SEC APPROVAL OF PROPOSED AMENDMENTS TO NASD RULES GOVERNING COMMUNICATIONS WITH THE PUBLIC

[16122] May 28, 2003 TO: ADVERTISING COMPLIANCE ADVISORY COMMITTEE No. 5-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 45-03 COMPLIANCE ADVISORY COMMITTEE No. 38-03 SEC RULES MEMBERS No. 64-03 SMALL FUNDS MEMBERS No. 23-03 UNIT INVESTMENT TRUST MEMBERS No. 17-03 RE: SEC APPROVAL OF PROPOSED AMENDMENTS TO NASD RULES GOVERNING COMMUNICATIONS WITH THE PUBLIC The Securities and Exchange Commission recently approved proposed revisions to the National Association of Securities Dealers rules governing communications with the public.¹ The revised rules will take effect on Monday, November 3, 2003. Set forth below is a summary of the amended rules. I. Amendments to Rule 2210 A. Definitions Various amendments have been made to Rule 2210's definitions. These include: • Adding a definition of "independently prepared reprints" and excluding such reprints from the Rule's definitions of "advertisement" and "sales literature;"² • Revising the definition of "advertisement" to include any material published or used in any electronic or other public media, including any website; • Revising the definition of "sales literature" to include press releases concerning a member's products or services; and • Including within the definition of "communications with the public": 1 See SEC Release No. 34-47820 (May 9, 2003), 68 Fed. Reg. 27116 (May 19, 2003)(the "Adopting Release"). Cites in this memorandum to the Adopting Release are to the version published in the Federal Register. The Adopting Release does not include the actual text of the NASDR's amended rules. According to the Adopting Release, the NASD will publish a Notice to Members announcing the SEC's approval of the revised rules by July 8, 2003, which will include the text of the revised rules. 2 See discussion of "independently prepared reprint" in the text, below. 2 • "institutional sales material," as defined in new Rule 2211, which is discussed below; and • a "public appearance," which is defined to include participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity. B. Independently Prepared Reprints/Investment Company Research Reports As mentioned above, as revised, Rule 2210 would treat "independently prepared reprints" as communications with the public, while excluding them from the definition of "advertisement" and "sales literature." Independently prepared reprints would continue to be subject to the content standards applicable to communications with the public (as set forth in Rule 2210(d)(1)) as well as to the pre-use approval and recordkeeping requirements of Rule 2210. Such reprints would not, however, be subject to the content

standards applicable to advertisements and sales literature, which are set forth in Rule 2210(d)(2). Those reprints and research reports that do not meet the definition of “independently prepared reprint” would remain subject to all of the requirements applicable to advertising and sales literature, including the content standards of Rule 2210(d)(2). Independently prepared reprints are also excluded from Rule 2210’s filing requirements. As defined in Rule 2210, the term “independently prepared reprint” would include both article reprints and research reports on investment companies that meet certain conditions. To qualify as an independently prepared reprint, the publisher of the article may not be an affiliate of the member using the reprint or any underwriter or issuer of the security mentioned in the reprint or excerpt that the member is promoting. With respect to research reports, to qualify as an independently prepared reprint: (i) the report must be prepared by a research firm, which is an entity that is independent of the investment company, its affiliates, and the member using the report; (ii) it may not be materially altered by the member except as necessary to comply with applicable regulatory standards or to correct factual errors; (iii) the research firm must prepare and distribute reports based on similar research with respect to a substantial number of investment companies and must update and distribute reports based on its research of the investment company with reasonable regularity in the normal course of the research firm’s business; neither the investment company, its affiliates, nor the member using the report may have commissioned the research used by the research firm in preparing the report; and, (iv) if a customized report was prepared at the request of the investment company, its affiliate, or a member, then the report must include only information that the research firm has already compiled and published in another report, and must not omit information in that report necessary to make the customized report fair and balanced.

C. Approval and Recordkeeping Subsection (b) of Rule 2210, which governs the approval and recordkeeping of communications with the public, has been revised to require members to maintain a file with: (1) the name of the registered principal who approved any advertisement or sales literature (though not the name of the person who prepared the items; see, however, Rule 2211, below); and (2) information concerning the source, but not necessarily the data, of any statistical table, chart, graph or other illustration.

3 D. Filing Requirements Subsection (c) of Rule 2210, which governs filing requirements, has been revised to: (1) require the filing of a copy of any ranking or comparison used in advertising or sales literature that includes or incorporates a performance ranking or performance comparison of the investment company with other investment companies; (2) clarify that advertising and sales literature for continuously offered closed-end funds must be filed; (3) clarify that a member that has filed a draft version of “story board” of a television or video advertisement pursuant to a filing requirement must also file the final filmed version within 10 business days of first use broadcast; (4) add a provision requiring each member’s written and electronic communications with the public to be submitted to the NASD upon request pursuant to its spot-check procedures; and (5) expand the list of the types of material that are excluded from the rule’s filing requirements. In particular, added to the list of exclusions are: (i) material that was previously filed and that is to be used without material change or that relates solely to recruitment or a change in the member’s e-mail or postal address; (ii) fund profiles that have been filed with the SEC; (iii) press releases that are made available only to members of the media; (iv) independently prepared reprints (as defined in the rule); (v) correspondence; and (vi) institutional sales material.³ According to the Adopting Release, members are also not required to file shareholder reports that only consist of statistical reporting information such as financial statements and portfolio holdings. They must, however, file with the NASD the management’s discussion of fund performance (MDFP) portion of a report as well as any supplemental sales material attached to or distributed with the report.

E. Content Standards Rule 2210 has been revised

to substantially shorten and simplify its content standards.⁴ Added to Rule 2210(d)(1), which governs standards applicable to all public communications, are: (1) an express requirement that all member communications “must be fair and balanced;” (2) a provision stating that information may be placed in a legend or footnote only if such placement would not inhibit an investor’s understanding of the communication; (3) a provision permitting the use of mutual fund cost calculators and other hypothetical illustrations of mathematical principal provided they do not predict or project the performance of an investment or investment strategy; and (4) a requirement that a person making a testimonial that concerns a technical aspect of investing be made by a person having the knowledge and experience to form a valid opinion. Rule 2210(d)(2), which governs standards applicable only to advertisements and sales literature, as revised requires: (1) advertisements or sales literature providing a testimonial concerning investment performance of a member or its products to prominently disclose information currently only required of testimonials concerning the quality of a firm’s 3 Notwithstanding these exclusions, in order to eliminate the need for these materials to be filed with the SEC the rule also provides that investment company communications described in items (iii)-(vi) shall be deemed filed with the NASD for purposes of Section 24(b) of the Investment Company Act of 1940 and Rule 24b-3, thereunder. 4 Certain of these standards have been moved to a new Interpretive Material 2210-1 (IM 2210-1), Guidelines to Ensure that Communications with the Public Are Not Misleading, which is discussed below. 4 investment advice; (2) advertisements or sales literature containing a comparison between investments or services to disclose all material differences between them, including (as applicable) investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features; and (3) all advertisements and sales literature, except “blind” advertisements used to recruit personnel, to include any relationship between the member and any non-member or individual also named in the material and, if the material includes other names, reflect the products or services being offered by the member. Finally, Rule 2210 has been revised to provide that any violation by a member of a rule of the SEC, the Securities Investor Protection Corporation (SIPC), or the Municipal Securities Rulemaking Board (MSRB) applicable to member communications with the public will be deemed a violation of Rule 2210.5 II. New Interpretive Material 2210-1, Guidelines to Ensure that Communications With the Public Are Not Misleading In addition to revising Rule 2210, the Adopting Release approved IM 2210- 1, which imposes content standards, many of which were previously in Rule 2210. According to its introductory language, the guidelines of the IM are not an exclusive list of considerations that a member must consider in ensuring that its communications are not misleading. The IM generally requires that statements not be misleading in the context in which they are made, members consider the nature of the audience to which the communication is directed, communications be clear, communications not refer to investment returns as tax-free or tax- exempt if tax liability is merely postponed or deferred, and references to tax-free or tax-exempt income must include which taxes apply, if any. III. Revisions to IM-2210-3, Relating to the Use of Rankings in Investment Company Advertisements and Sales Literature The Adopting Release also adopts various revisions to IM-2210-3, relating to the use of rankings in investment company advertisements and sales literature. As revised, the IM prohibits the use of rankings other than rankings (1) created and published by a ranking entity (as defined in the IM) or (2) created by an investment company or investment company affiliate but based on the performance measurements of a ranking entity. The IM requires express disclosure of the fact that past performance is no guarantee of future results in all advertisements and sales literature containing an investment company ranking. As regards currentness, a ranking in sales literature must be current to the most recent calendar quarter ended prior to use; a ranking in an advertisement must be current to the most

recent calendar quarter ended prior to the submission for publication. If no ranking meeting these requirements is available from the ranking entity, the member may only use the most current ranking available unless such use would be misleading, in which case no ranking may be used. Added to the IM is a new subsection (g), which permits the use of rankings of investment company families upon compliance with two conditions. These two conditions are that the family rankings are compliant with the guidelines imposed by the IM on investment 5 A similar provision has been added to new Rule 2211, which is discussed below. 5 company rankings and the advertisement or sales literature also prominently discloses the various rankings for the individual investment company supplied by the same ranking entity. As used in the IM, the term "investment company family" is defined to mean any two or more registered investment companies or series thereof that hold themselves out to investors as related companies for purposes of investment and investor services. IV. New Rule 2211, Institutional Sales Material; Form Correspondence A. Definitions The Commission has approved adoption of new NASD Rule 2211 to govern institutional sales material and form correspondence. As defined in this new rule, the term "correspondence" means any written letter or e-mail distributed by a member to one or more of its existing retail customers and fewer than 25 prospective retail customers within any 30 calendar-day period. "Institutional sales material" is defined as communications distributed or made available only to institutional investors, which includes: a person described in NASD Rule 3110(c)(4) (i.e., an entity with total assets of at least \$50 million); government entities; employee benefit plans that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code so long as they have at least 100 participants; a qualified plan, as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934, that has at least 100 participants; NASD members or their registered associated persons;⁶ and persons acting solely on behalf of any such institutional investor. No communication may be treated as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt thereof would be forwarded or made available to any person other than an institutional investor. B. Approval and Recordkeeping Rule 2211 subjects institutional sales material to new supervision and review requirements, but eliminates the pre-use approval and filing requirements and some of the content standards applicable to other communications with the public under Rule 2210. In particular, the rule requires each member to establish written procedures that are appropriate to its business, size, structure, and customers for the review by a registered principal of institutional sales material used by the member and its representatives. These procedures should be in writing and designed to reasonably supervise each registered representative. If the procedures do not require review of all institutional sales material prior to use or distribution, they must provide for the education and training of associated persons as to the firm's procedures governing institutional sales material, documentation of such education and training, and surveillance and follow-up to ensure that such procedures are implemented and adhered to. Evidence of compliance must be maintained and made available to the NASD upon request. Members are also required to maintain all institutional sales material in a file, which includes the name of the person who prepared the material, for at least three years from the 6 As regards inclusion of NASD members in this definition, the Adopting Release notes that two commenters had recommended that the definition of "institutional investor" not include such persons inasmuch as "broker/dealer- only communications are not covered by NASD Rule 2210." According to the Adopting Release, "The NASD disagreed with this contention noting that while NASD Rule 2210 excepts internal-use only materials from its filing requirements, the NASD has long taken the position that broker/dealer-only materials must meet the rule's content requirements." (See Adopting Release at p. 27121 (footnotes omitted).) 6 date of last use. Members must also maintain in a file information concerning the source of any statistical table, chart, graph, or

other illustration used by the member in communications with the public. A member's correspondence and institutional sales literature may be subject to the NASD's spot check procedures under Rule 2210. Upon written request from the NASD, a member must submit for a spot check the material requested within the time frame specified by the NASD. C. Content Standards The rule incorporates by reference the content standards of NASD Rule 2210(d)(1) (but not the content standards of Rule 2210(d)(2)) and applicable Interpretive Materials under Rule 2210, which are discussed above. In addition, all correspondence, including business cards and letterhead, must include certain disclosures relating to the member's name and relationships between members and non-members included in the correspondence. Members are prohibited from using investment company rankings in any correspondence, other than rankings based either on a category or subcategory created and published by a "ranking entity" as defined in IM-2210-3(a) or a category or subcategory created by an investment company or an investment company affiliated but based on the performance measurements of a ranking entity. Tamara K. Salmon Senior Associate Counsel

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