

MEMO# 18130

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SEC APPROVES NASD PROPOSAL RELATING TO USE OF INVESTMENT ANALYSIS TOOLS

[18130] October 22, 2004 TO: ADVERTISING COMPLIANCE ADVISORY COMMITTEE No. 6-04 INVESTMENT ADVISERS COMMITTEE No. 16-04 PENSION COMMITTEE No. 50-04 SEC RULES COMMITTEE No. 82-04 RE: SEC APPROVES NASD PROPOSAL RELATING TO USE OF INVESTMENT ANALYSIS TOOLS The Securities and Exchange Commission has approved Interpretive Material (IM) that would permit the use of investment analysis tools under the NASD's rules under certain conditions.¹ In particular, this new IM, IM-2210-6, which was originally proposed by the NASD over two years ago, would provide a limited exemption for investment analysis tools from the provisions of NASD Rule 2210(d)(2)(N), which prohibits NASD members from making predictions or projections of investment results to the public. Since its original proposal, the IM was substantially revised to address concerns with it that were raised by the Institute and others. The adopted version of the IM is summarized below. The effective date of the IM will be set forth in a Notice to Members that the NASD will be publishing about it in the near future. Members may not rely on the IM prior to its effective date. THE PROVISIONS OF IM-2210-6 IM-2210-6 permits the use of any "investment analysis tool" as defined in the IM provided the member complies with disclosure and filing requirements described below. These requirements apply to tools provided by the member that a customer uses independently as well as to those used with assistance from the member. Definition of "Investment Analysis Tool" The term "investment analysis tool" is defined in the IM as any: 1 See SEC Release No. 34-50463, 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 (Sept. 28, 2004), 69 Fed. Reg. 60200 (Oct. 7, 2004) (the "Release"). The IM was originally proposed in August 2002. See Institute Memorandum to Advertising Compliance Advisory Committee No. 15-02, Investment Advisers Committee No. 15-02, Pension Committee No. 33-02, and SEC Rules Committee No. 65-02 [15056], dated August 20, 2002, which summarized the NASD's proposal as set forth in NASD Notice to Members 02-51 (August 2002). 2 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. This definition was broadened from that originally proposed to address commenters' concerns with the fact that the original definition would have only permitted the use of tools that show the probability that investing in specific securities or mutual funds will produce a desired result.

As revised, the definition will permit the use of those tools that show how classes of financial assets or styles of investing might perform. Required Disclosures The IM permits a member of the NASD to (1) use or offer to its customers an investment analysis tool and (2) provide its customers related sales material and written reports indicating the results of the tools without running afoul of Rule 2210(d)(2)(N) provided the member provides the following disclosures clearly and prominently in written or electronic narrative form: • A description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions; • An explanation that results may vary with each use and over time; and • If applicable, a description of the universe of investments considered in the analysis including: an explanation of how the tool determines which securities to select; disclosure of whether the tool favors certain securities and, if so, an explanation of the reason for the selectivity; and a statement that other investments not considered may have characteristics similar or superior to those being analyzed. The member must also display the following: "IMPORTANT: The projections or other information generated by [name of 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." These conditions vary significantly, and are far less onerous, than those originally proposed by the NASD. For example, the NASD has dropped the requirements that the tool use a mathematical process that could be audited and reviewed and that presents a range of probabilities, including upside, downside, and median projections. Also, the disclosure requirements no longer require all sales literature that merely mentions the tool to include the IM's required disclosures.

2 Filing Requirement; Exclusion Provided for Institutional Investors 2 According to the Release, sales material that contains an incidental reference to an investment analysis tool need not include these disclosures and would not need to be filed with the NASD under the IM's filing requirements. See Release at n.3 p. 60206. 3 As adopted, the IM requires a member that uses an investment analysis tool to provide the NASD's Advertising Regulation Department access to the tool within 10 days of first use. In addition, the member must file with the Department any template for written reports produced by, or sales material concerning, the tool. To the extent the member makes any material changes to the tool after it has been reviewed by the NASD, the member must provide the NASD additional access to the tool. Similarly, any material changes made to the written reports or sales material after they were filed with and reviewed by the NASD would require their refiling with the NASD. Investment analysis tools that are offered exclusively to "institutional investors" (as defined in NASD Rule 2211(a)(3)) are not subject to these requirements, provided that the communications relating to or produced by the tool are "institutional sales material" under NASD Rule 2211(a)(2). These requirements have been substantially revised from the NASD's original proposal. As originally proposed, the IM would have required members to provide the NASD access to the tool and the filing of all sales material concerning the tool at least 30 days prior to use of the tool. The original proposal also would have prohibited use of the tool or sales material until any changes requested by the Department were made by the member and approved by the Department and it did not include the exclusion for tools used exclusively by institutional investors.

Caveat The IM reminds members, in connection with use of any investment analysis tool and any recommendations resulting from use of such tool, of their responsibility to ensure compliance with the NASD's rules (particularly those relating to suitability (Rule 2310) and fair dealing with customers (Rule 2210)), the federal securities laws, and the rules of the SEC. • • • • • Tamara K. Salmon Senior Associate Counsel

should not be considered a substitute for, legal advice.