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**UNITED STATES OF AMERICA**
**BEFORE THE SECURITIES AND EXCHANGE COMMISSION**

IN THE MATTER OF:

MICHAEL A. HOROWITZ and
MOSHE MARC COHEN

RESPONDENTS.

ADMINISTRATIVE PROCEEDING
FILE NO: 3-15790

# RESPONDENT MOSHE MARC COHEN'S MOTION FOR LEAVE TO FILE A MOTION OF DISPOSITION AS TO "IMMATERIALITY" OF "INVESTMENT ACCESS" UNDER THE 2008 SUITABILITY REQUIREMENTS

Respondent Moshe Marc Cohen ("Respondent") respectfully requests the Court's Leave to file a Motion of Disposition as to the Division's alleged violations of a "misrepresentation" as to the "Investment Access" response in a Pre-FINRA 2821 era as well as to their posturing that the "Investment Access" question is "material".

## INTRODUCTION

The Division in their "Reply to Cohen's Opposition to its Motion to Quash and for a Protective Order Regarding Subpoenas to Division Counsel" on August 6, 2014 stated the following.

On Page 1 of the Division's Reply the Division stated the following *"the only relevant facts in this case concern his representation to his broker dealer, Woodbury Financial Services ("Woodbury"), in connection with the issuance of variable annuities measured by the lives of terminally ill people."* They then continue with the following *"This case is not about whether insurance companies were defrauded by Cohen's acts. Indeed the OIP is clear about the Division's claim against Cohen."* They then quote paragraphs 99, 100 and 101 of the OIP which are.

99. As part of the principal review, Broker-Dealer 3 principals scrutinized the investment access information that Cohen provided on behalf of his customers to ensure that that each customer would not need access to their investment during the surrender charge period in the annuity being purchased. Each of the variable annuity products that Cohen sold had a surrender charge period of at least 7 years.

100. Knowing that Broker-Dealer 3 would not approve his variable annuity sales if he provided truthful investment access information for his customers, Cohen provided false information regarding how soon the customers intended to access the investment (i.e., not before "11 to 15 years") on each of the 28 Broker-Dealer 3 "Annuity-Point of Sale" forms that he completed.

101. By providing false investment access information for the nominees of Institutional Investor 1, and by failing to disclose that they intended to access their annuities well within the surrender charge period, Cohen was able to fraudulently obtain principal approval of his stranger-owned annuities sales. As a result of Cohen's fraudulent acts and practices, the insurance companies whose variable annuities Cohen sold unwittingly issued stranger-owned variable annuities to Cohen's customers, and paid out substantial upfront sales commissions to Cohen.

OIP at Paragraphs 99-101.

The Division then makes the following statement *"As such, any facts that do not concern the above alleged conduct are not relevant to any aspect of this case."*

The Division's reply and own admission clearly and factually show that their only allegation in the OIP is the "alleged" misrepresentation of the "investment access" question on Woodbury's Annuity Point-of Sale form.

In the Division's Pre-hearing brief dated August 20, 2014, they state the following: "the Division's case against Respondent Marc Cohen is a "straightforward misrepresentation case".

The Rules of Practice under Rule 250 states "

(b) The hearing officer shall promptly grant or deny the motion for summary disposition or shall defer decision on the motion. The hearing officer may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law

As such, Respondent Cohen respectfully requests for a Leave to file a Motion of Disposition as to fact that "Investment Access" was not "material" under the Securities and FINRA regulations in January and February of 2008.

It is a matter of material fact and well established that "Investment Access" and "Time Horizon" are two distinct and different questions.

On numerous occasions, the Division in their responses and motions have incorrectly interchanged the two. Whether done intentionally or not, is not relevant to this motion. Nor does it change what the alleged misrepresentation is about-- "Investment Access".

It is also a Matter of Law that "Investment Access" is interchangeable with the SEC and FINRA used term of "Liquidity Needs".

So as a matter of Law—"Investment Access" is the same as "Liquidity Needs".

In June of 2004, in a Joint SEC/NASD Report titled "ON EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS" the Securities and Exchange Commission together with NASD (now FINRA) list the requirements of the "Suitability Review Requirements" under NASD Rule 2310 which was the rule in effect during January and February of 2008.

This report States the following:

**III. Examination Findings**

**A. Suitability, Sales Practices, and Conflicts of Interests**

A broker-dealer recommending a variable product to an investor must assess the investor's financial status, investment objectives, and other relevant information to determine if the product is suitable. The obligation to recommend only securities that are suitable for the customer arises from the antifraud provisions of the federal securities laws, and from rules of the self-regulatory organizations ("SROs"). A broker-dealer, by hanging out its "shingle" and conducting a public securities business, impliedly represents that it will deal fairly with customers.[5] As part of this obligation of fair dealing, broker-dealers must have a reasonable basis for believing that their securities recommendations are suitable for the customer in light of the customer's financial needs, objectives and circumstances. In addition, broker-dealers must have a reasonable basis for believing that the particular security being recommended is appropriate. Under NASD Rule 2310 and IM 2310-2, when a broker-dealer recommends a security to a customer, it must determine that the security is suitable for that customer in light of that customer's particular age, financial situation, risk tolerance, and investment objectives. Because variable annuities and variable life insurance are complex products, the NASD has issued additional guidance in assessing the suitability of recommendations of variable products in Notices to Members ("NTM") 96-86, 99-35, and 00-44.

In addition to existing securities laws and rules governing suitability, the National Association of Insurance Commissioners ("NAIC") has expressed concern regarding the sale of variable annuities to seniors. As a result of these concerns, on September 14, 2003 the NAIC adopted a Model Regulation entitled Senior Protection in Annuity Transactions. The model regulation, which was adopted as a model for state legislation, requires insurers and producers to use standards similar to those required by the NASD for variable products to evaluate the suitability of recommendations.

Based on this SEC/ NASD Report there is no mention of either "Investment Access" or "Liquidity Needs".

The only requirements needed by a broker-dealer or a registered representative in a recommendation of a security is

1. Particular Age
2. Financial Situation
3. Risk Tolerance
4. Investment Objectives

There is clearly no mention of either "Investment Access" or Liquidity Needs" in this report or in FINRA Rule 2310 that regulated recommended sales of securities in January and February 2008 thus making both of **these terms "immaterial" as to suitability at the time of sales of these annuities and thus require the disposition of this proceeding.**

Because Variable Annuities are complex products FINRA/NASD has issued additional guidance in assessing the suitability of "recommendations" of variable products in NTM's 99-35.

Although the word "liquidity" is addressed in FINRA NTM 99-35 which states the following, it does not make it a requirement of suitability – rather a suggestion to be aware of. **This would make the "investment Access" question "immaterial" requiring the disposition of this proceeding.**

### 7.Liquidity And Earnings Accrual

Lack of liquidity, which may be caused by surrender charges or penalties for early withdrawal under the Internal Revenue Code, may make a variable annuity an unsuitable investment for customers who have short-term investment objectives. Moreover, although a b e n e fit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds.

NASD NTM 99-35 page 2.

Based on the above, the arguments made by the Division that forbids a short-term investment of variable annuities is wrong too but not the point of this motion. The liquidity statement above was only a suggestion and not a rule.

Regardless of this fact, there was no requirement within suitability during January and February of 2008 for the representative or the Broker-Dealer to ask about "Liquidity Needs". The above NTM 99-35 as well the Joint SEC and NASD as well as Rule 2821 (effective date of 5/8/08 3 months after these annuities were put in force) was a mere guidance to be mindful of the fact that variables annuities "may" not be the best option if liquidity needs exist. Hence, **the "Investment Access" question in the Annuity Point of Sale form remains "immaterial" requiring the disposition of this proceeding**.

The SEC will not be able to show that there were any requirements demanding "Investment Access" in effect at the time of the sales in question, being that FINRA Rule 2821 only went into effect on May 8th, 2008 which spelled out "liquidly needs" as being material was not in effect during January and February of 2008. That being the case and as a matter of law, **this should preclude the Division from bringing this "immaterial misrepresentation" case in any forum or court**.

Note that the above "matter of law" fact of the "Investments Access" question, being deemed as "immaterial" are true if these sales were deemed to be solicited or recommended sales by the Court. (The Division has affirmatively stated that these sales were not solicited as part of their OIP complaint against Cohen). Surely, if these sales are correctly deemed to be unsolicited or not-recommended this would automatically deem this question as a matter of law to be deemed "immaterial".

So regardless of how the Court or the Division characterize these sales, the fact and matter of law on the "Investment access" question should deem this "immaterial".

The fact that there was an affirmative response to the "investment access" question by Cohen whether it is deemed to be correct statement or not, would not change the fact that this question remained "immaterial" under federal law as referenced to in end note 7 of NTM 01-23.

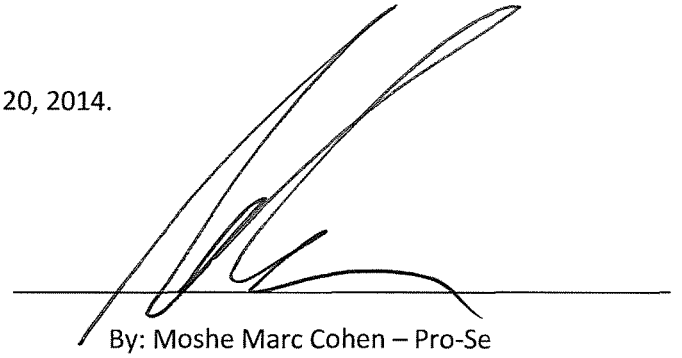
> "Finra (NASD) Online Suitability NTM 01-23 states in Endnote 7 "A member or associated person who simply effects a trade initiated by a customer without a related "recommendation" from the member or associated person is not required to perform a suitability analysis, although members may elect to determine 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). The end of the End Note 7 continues ("[T]he NASD and other suitability rules have long applied only to 'recommended' transaction."); Clarification of 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 generally gathered to satisfy a suitability obligation."**

Allowing the Division to retroactively change this "Investment Access" question to a "material" statement trying to use Finra Rule 2821 violates every protection right afforded Cohen to a fair trial under the US Constitution.

## Conclusion

As such, Respondent Cohen respectfully requests that the Court either grant leave to file a Motion of Disposition as to the "immateriality" of "Investment Access" question; or even the issuance of a Court Order of Disposition or Dismissal based on the "Matter of Law" and fact that "Investment Access" being "immaterial" without Respondent having to file a Motion of Disposition. As hearing is only days away, we respectfully request an expedited Leave or Ruling on this as the other pending matters in the Court.

Respectfully Submitted August 20, 2014.



By: Moshe Marc Cohen – Pro-Se

# EXHIBIT A

FINRA

NEWS RELEASE

**For Release:** Tuesday, November 6, 2007
**Contacts:** Nancy Condon (202) 728-8379
Herb Perone (202) 728-8464

## FINRA Publishes Guidance, Text for New Rule Governing Deferred Variable Annuity Transactions

**Washington, DC** — The Financial Industry Regulatory Authority (FINRA) today published guidance to firms on a new rule covering transactions in deferred variable annuities. FINRA Regulatory Notice 07-53 outlines the provisions of Rule 2821, which will become effective on May 5, 2008.

Deferred variable annuities are hybrid investments containing both securities and insurance features. They offer choices among a number of complex contract options, which can be confusing for both the individuals who sell them and customers who buy them. FINRA developed Rule 2821 to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors who buy or exchange deferred variable annuities.

Rule 2821 imposes requirements in four main areas.

### Registered Representative Requirements for Recommended Transactions

When recommending a deferred annuity transaction, a registered representative must:

- Make a reasonable effort to obtain and consider various types of customer-specific information, including age, income, financial situation and needs, investment experience and objectives, intended use of the deferred variable annuity, investment time horizon, existing assets, liquidity needs, liquid net worth, risk tolerance and tax status.
- Have a reasonable basis to believe the customer has been informed of the material features of a deferred variable annuity, such as a surrender charge, potential tax penalty, various fees and costs, and market risk.
- Have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization or death or living benefits.
- Make a customer suitability determination as to the investment in the deferred variable annuity, the investments in the underlying sub-accounts at the time of purchase or exchange, and all riders and other product enhancements and features contained in the annuity contract.
- Have a reasonable basis to believe that a deferred annuity exchange transaction is suitable for the particular customer, considering, among other factors, whether the customer would incur a surrender charge, be subject to a new surrender period, lose existing benefits, be subject to increased fees or charges, and has had another exchange within the preceding 36 months.

#### Principal Review and Approval Obligations for All Transactions

The new rule requires a registered principal to review and determine whether to approve the customer's application for a deferred variable annuity before transmitting the application to the issuing insurance company, but no later than seven business days after the customer signs the application. A principal must treat all transactions as if they have been recommended for purposes of review and can approve the transaction only if it is suitable based on the factors that a registered representative must consider when making a recommendation. However, the principal *may* authorize the processing of the transaction even if he or she does not approve it based on suitability if, but only if, the following two determinations are made: (1) the transaction was not recommended and (2) the customer, after being told why the principal found it to be unsuitable, still wants to proceed with the purchase or exchange.

#### Firm Supervisory Procedures

Rule 2821 requires broker-dealers to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the rule's standards. That includes requirements that the broker-dealer implement surveillance procedures to determine whether any brokers have rates of effecting variable annuity exchanges that might evidence misconduct, and have policies and procedures in place to address inappropriate exchanges.

#### Firm Training Program

The new rule requires firms to create training programs for registered representatives who sell deferred variable annuities and for registered principals who review deferred variable annuity transactions.

The full text of Rule 2821 is available at www.finra.org/notices/07-53.

FINRA, the Financial Industry Regulatory Authority, is the largest non-governmental regulator for all securities firms doing business in the United States. Created in 2007 through the consolidation of NASD and NYSE Member Regulation, FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA touches virtually every aspect of the securities business—from registering and educating all industry participants to examining securities firms; writing and enforcing rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. For more information, please visit our Web site at www.finra.org.

# EXHIBIT B

# Regulatory Notice 07-53

# Deferred Variable Annuities

## SEC Approves New NASD Rule 2821 Governing Deferred Variable Annuity Transactions

Effective Date: May 5, 2008

## Executive Summary

On September 7, 2007, the SEC approved new NASD Rule 2821 regarding broker-dealers' compliance and supervisory responsibilities for deferred variable annuities.[1] The rule text is set forth in Attachment A and is effective May 5, 2008.

Questions regarding this *Notice* may be directed to James S. Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; or Lawrence N. Kosciulek, Director, Investment Companies Regulation, at (240) 386-4535.

## Discussion

Deferred variable annuities are hybrid investments containing both securities and insurance features.[2] They offer choices among a number of complex contract options, which can cause confusion for both the individuals who sell them and customers who buy them. FINRA developed Rule 2821 to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities.

**November 2007**

Notice Type
- New Rule

Suggested Routing
- Compliance
- Continuing Education
- Internal Audit
- Legal
- Operations
- Registered Representatives
- Senior Management
- Systems
- Trading
- Training
- Variable Contracts

Key Topics
- Deferred Variable Annuities
- Disclosure
- Principal Review
- Sales Practices
- Suitability
- Supervision
- Training

Referenced Rules & Notices
- NASD Rule 2310
- NASD Rule 2330
- NASD Rule 2820
- NASD Rule 2821
- NASD Rule 3010
- NASD Rule 3012
- NTM 99-35
- NTM 01-23
- NTM 03-71
- NTM 05-50
- NYSE Information Memo 05-54
- SEC Rule 15c3-1
- SEC Rule 15c3-3

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## The Rule's Application

Rule 2821 applies to the purchase or exchange (not sale or surrender) of a deferred variable annuity and the initial subaccount allocations.[3] Rule 2821 does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. Other FINRA rules, however, are applicable to such transactions. For instance, FINRA's general suitability rule (NASD Rule 2310) continues to apply to any recommendations to reallocate subaccounts or to sell a deferred variable annuity.[4] Rule 2821 applies to the use of deferred variable annuities to fund IRAs, but not to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans,[5] unless a member firm makes a recommendation to an individual plan participant, in which case the rule would apply to that recommendation.[6]

## The Rule's Main Requirements

Rule 2821 has four main requirements, which are discussed below. An outline of the general division of responsibility among registered representatives, registered principals and firms is included with this *Notice* (Attachment B). Firms and their associated persons should carefully review the actual rule language, however, to understand the breadth of the obligations that the rule imposes.

### Registered Representative Requirements for Recommended Transactions

Under the "Recommendation Requirements" section of the rule,[7] a registered representative must have a reasonable basis to believe that the customer has been informed, in general terms, of the material features of a deferred variable annuity, such as potential surrender period and surrender charge, potential tax penalty, mortality and expense fees, charges for and features of enhanced riders, insurance and investment components and market risk.[8] Although the rule requires only generic disclosure, registered representatives and principals may not ignore product-specific features. For example, a firm and its brokers cannot adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question.[9]

This section of the rule also requires that the registered representative have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization or a death or living benefit.[10] The rule does not require that a registered representative determine that the customer would benefit from *all* of these features or that the customer, in hindsight, actually took advantage of one or more of them.

Further, this section states that a registered representative must have a reasonable basis to believe that "the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable...."[11] Thus, the suitability determination must include careful consideration of the product in its entirety and its component parts, including initial subaccount allocations.

If an "exchange" of one variable annuity for another is involved, the registered representative must have a reasonable basis to believe that "the transaction as a whole also is suitable for the particular customer" and must consider a number of additional factors.[12] Those factors include "whether (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, ... or be subject to increased fees or charges....; (ii) the customer would benefit from product enhancements and improvements; and (iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months."[13] Regarding the last factor, a registered representative must determine whether the customer has effected another exchange at the broker-dealer at which he or she is performing the review and must make reasonable efforts to ascertain whether the customer has effected an exchange at any other broker-dealer(s) within the preceding 36 months.[14]

The rule also requires a registered representative to make reasonable efforts to ascertain and consider various other types of customer-specific information when recommending that a customer purchase or exchange a deferred variable annuity. This information includes the customer's "age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers."[15] Although not explicitly addressed in the rule, deferred variable annuities generally are considered to be long-term investments and are therefore typically not suitable for investors who have short-term investment horizons.

Finally, a registered representative who recommends the purchase or exchange of a deferred variable annuity must document and sign the determinations discussed above. This signed document must provide reviewing principals with enough information to adequately assess whether the registered representative has complied with the requirements of Rule 2821.

**Principal Review and Approval Obligations for All Transactions**

The rule's "Principal Review and Approval" section includes both timing and substantive components. With regard to timing, the rule requires review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after the customer signs the application...."[16] FINRA recognizes that (in view of the variety of features and provisions of deferred variable annuity contracts) principal review of these investments often can require more time than reviews of many other types of securities transactions. To ensure that broker-dealers have sufficient time for a rigorous and thorough review prior to transmittal, FINRA has provided interpretive relief and the SEC has provided an exemption (as described below) regarding a number of rules that otherwise might have, as a practical matter, shortened the period within which broker-dealers could review the transactions.

Broker-dealers often accept customer checks made payable to the issuing insurance company when customers sign applications for deferred variable annuities. The broker-dealers' receipt of the checks, however, could have triggered application of a number of other rules that might have required relatively quick principal reviews. NASD Rule 2330, for instance, generally prohibits improper use of customer funds, and NASD Rule 2820 specifically requires broker-dealers to "transmit promptly" the application and purchase payment for a variable annuity contract to the issuing insurance company. To alleviate the potential conflict between Rule 2821's review timing requirement and other FINRA rules, FINRA created an important exception: A broker-dealer may hold an application for a deferred variable annuity and a customer's non-negotiated check payable to an insurance company for up to seven business days without violating either Rule 2330 or Rule 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to Rule 2821.

An SEC exemption also was needed because "[m]any broker-dealers are subject to lower net capital requirements under [SEC] Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under [SEC] Rule 15c3-3 because they do not carry customer funds or securities."[17] Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it "promptly transmits" the checks to third parties.[18] The SEC has interpreted "promptly transmits" to mean that "such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities."[19]

In conjunction with its approval of Rule 2821, the SEC provided an exemption to the "promptly transmits" requirement under the following conditions:

- The transaction is subject to the principal review requirements of Rule 2821 and a registered principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with the rule;
- The broker-dealer promptly transmits the check no later than noon of the business day following the date a registered principal reviews and determines whether he or she approves of the purchase or exchange of the deferred variable annuity; and
- The broker-dealer maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company if approved or returned to the customer if rejected.

If all three of these conditions are met, a firm is "exempt from any additional requirements of [SEC] Rules 15c3-1 or 15c3-3 due solely to a failure to promptly transmit a check made payable to an insurance company for the purchase of a deferred variable annuity product by noon of the business day following the date the broker-dealer receives the check from the customer...."[20]

During the rulemaking process, some commenters asked whether principals must complete or simply begin their review prior to the transmittal of the application to the issuing insurance company. The principal review must be *completed* before transmittal of the application to the insurance company.

A coalition of 32 life insurance companies asked whether the timing of principal review under Rule 2821 would be impacted by a firm's status as a "captive broker-dealer." The coalition explained that a number of insurance companies share personnel with affiliated broker-dealers and have centralized units that may share personnel who are responsible for both the broker-dealer's principal review of the variable annuity application and the insurance company's issuance process. The coalition sought clarification that receipt of customer applications by broker-dealer personnel for principal review, even if those personnel share office space with and/or also work for the insurer, would not be considered "transmitted to the issuing insurance company for processing" under Rule 2821.

To respond to the coalition's request for clarification, it is necessary to emphasize that the main purpose of requiring pre-transmittal principal review is to have the principal review and determine whether to approve the application *prior to the issuance of the contract*. Ordinarily, FINRA would consider the application "transmitted" to the insurance company when the broker-dealer sends the application to the insurance company for processing, whether it is sent via electronic means, facsimile transmission,

regular or overnight mail, or courier. The dividing lines can become blurred, however, when a captive broker-dealer and insurance company share office space and/or employees who carry out both the principal review and the issuance process. In such situations, FINRA considers the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer ensures that arrangements and safeguards exist to prevent the insurance company from issuing the contract prior to principal approval by the broker-dealer.[21]

In addition to addressing the timing of principal review, this section of the rule states that a principal shall treat "all transactions as if they have been recommended for purposes of this principal review" and shall only approve the transaction if he or she determines "that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule."[22] A principal who determines that the transaction is unsuitable nonetheless may authorize the processing of the transaction if the principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the principal found it to be unsuitable, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. All of the determinations required by this part of the rule must be documented and signed by the principal.

FINRA emphasizes, however, that the rule does not *require* broker-dealers to effect trades that they determine are not suitable; rather, the rule *permits* them to do so under the narrow circumstances discussed above. Thus, the rule has no effect on existing principles of law or contractual terms that allow a broker-dealer to decline the acceptance of an order.

A few commenters asked whether principals have a more limited role under the rule if they are employed by a broker-dealer that does not have a sales force and does not make recommendations to customers.[23] The rule requires that a broker-dealer have procedures in place designed to ensure that principals receive appropriate information about both the customer and the product(s) so that they can fulfill their review obligations under the rule and that principals review *all* purchase and exchange orders for suitability, irrespective of whether the orders were recommended.

### Firm Supervisory Procedures

The rule specifically requires broker-dealers to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the rule.[24] This part of the rule includes the requirements that the broker-dealer implement surveillance procedures to determine if any "*associated persons* have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ('inappropriate exchanges') and have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges...."[25] The rule allows a firm to determine how to screen for and supervise such activity. Thus, a firm could perform this type of review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction.

### Firm Training Program

The fourth main requirement in the rule is a training component,[26] which requires that firms create training programs for registered representatives who sell, and for registered principals who review transactions in, deferred variable annuities. Among other factors, firms must include training on the material aspects of deferred variable annuities.

## Use of Automated Supervisory Systems

Rule 2821 does not preclude firms from using automated supervisory systems (or a mix of automated and manual supervisory systems) to facilitate compliance with the rule. Of course, firms that intend to rely on automated supervisory systems for compliance with Rule 2821 (or other rules) must remember that, at a minimum, a principal or principals would need to (1) approve the criteria that the automated supervisory system uses; (2) audit and update the automated supervisory system as necessary to ensure compliance with the rule; and (3) review exception reports that the automated supervisory system creates. As is always the case with the exercise of supervision under FINRA rules, the use of any automated supervisory system, aid or tool for the discharge of supervisory duties represents a direct exercise of supervision by the supervisor (a principal or principals under Rule 2821) and the supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule. Consequently, a principal or principals relying on such an automated supervisory system is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed to comply with Rule 2821.

A broker-dealer need not designate only one principal to perform these tasks. Consistent with NASD Rules 3010 and 3012, a broker-dealer generally is free to allocate supervisory responsibilities among its qualified registered principals as appropriate (whether in the context of automated or manual supervisory reviews). Thus, a broker-dealer may, for example, designate several principals to be responsible for various parts of an automated supervisory system.

Finally, a broker-dealer must ensure that it provides training for (1) the firm's relevant associated persons on how to correctly input information into the automated supervisory system and (2) the firm's principals responsible for reviewing and approving deferred variable annuity transactions on how to use and interpret the reports generated by the firm's automated supervisory systems in order to properly review and monitor deferred variable annuity transactions.[27]

## Endnotes

1 *See* SEC Order Approving FINRA's NASD Rule 2821 Regarding Members' Responsibilities for Deferred Variable Annuities (Approval Order), Securities Exchange Act Release No. 56375 (Sept. 7, 2007), 72 FR 52403 (Sept. 13, 2007) (SR-NASD-2004-183); SEC Corrective Order, Securities Exchange Act Release No. 56375A (Sept. 14, 2007), 72 FR 53612 (Sept. 19, 2007) (SR-NASD-2004-183) (correcting the rule's effective date). Created on July 30, 2007, the Financial Industry Regulatory Authority (FINRA) comprises the former National Association of Securities Dealers, Inc. (NASD) and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE). The FINRA rulebook consists of both NASD rules and certain NYSE rules until FINRA adopts a consolidated rulebook.

2 In general, a variable annuity is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). *See* Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint Report), available at *www.sec.gov/news/ studies/secnasdvip.pdf*; *see also NASD Notice to Members 99-35* (May 1999); *NYSE Information Memo 05-54* (Aug. 11, 2005).

3 Rule 2821(a)(1). The rule covers a stand-alone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another. For purposes of the rule, an "exchange" of a product other than a deferred variable annuity (such as a fixed annuity) for a deferred variable annuity would be covered by the rule as a "purchase." The rule does not cover customer sales or surrenders of deferred variable annuities, including the sale or surrender of a deferred variable annuity in connection with an "exchange" of a deferred variable annuity for another product (such as a fixed annuity).

4 In a 2002 *Regulatory & Compliance Alert* entitled "Reminder—Suitability of Variable Annuity Sales," FINRA emphasized that Rule 2310 "applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor." *Regulatory & Compliance Alert* (Spring 2002) at 13. *See also NASD Notice to Members 05-50* (Aug. 2005) ("[R]recommendations to ... surrender a ... variable annuity ... must be suitable, including where such ... surrender[s] are for the purpose of funding the purchase of an unregistered EIA."). As part of the suitability analysis under Rule 2310 regarding a recommendation to sell a deferred variable annuity, a registered representative must consider, *inter alia*, tax consequences, surrender charges and loss of benefits (such as death, living or other contractual benefits).

5 A deferred variable annuity purchased to fund an IRA (or other tax deferred account or vehicle) does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA (or other tax deferred account or vehicle) itself. Accordingly, where a customer is purchasing a deferred

## Endnotes (cont'd)

variable annuity to fund an IRA (or other tax deferred account or vehicle), firms must ensure that features other than tax deferral make the purchase of the deferred variable annuity for the IRA (or other tax deferred account or vehicle) appropriate.

6 Another issue that arose during the rulemaking process is whether Rule 2821 would apply if a registered representative recommended a deferred variable annuity to an individual retirement plan participant and the annuity was the only funding vehicle for the employer's retirement plan. If the registered representative "recommends" the deferred variable annuity, then Rule 2821 would apply. However, not all communications about a deferred variable annuity would constitute a "recommendation" that triggers application of the rule. For instance, a firm's generic communication to plan participants indicating only that their employer has chosen a deferred variable annuity as the funding vehicle for its retirement plan generally would not constitute a "recommendation" triggering application of the rule. For a review of guidelines for determining whether a particular communication could be deemed a "recommendation," *see NASD Notice to Members 01-23* (Apr. 2001).

7 Rule 2821(b).

8 Rule 2821(b)(1)(A)(i). While the rule does not specify the exact type or form of disclosure that is required, a registered representative who merely delivers a prospectus to an investor ordinarily would not have a reasonable basis to believe that the customer has been instructed or educated—"informed"—about the material features of a deferred variable annuity for purposes of the rule.

9 A broker's understanding of the features of an investment product is an important component of both reasonable-basis suitability (*i.e.*, the requirement that a broker determine, after appropriate due diligence, whether the product is suitable for at least *some* investors) and customer-specific suitability (*i.e.*, the requirement that the broker determine whether the product is suitable for the particular customer at issue). *See NASD Notice to Members 03-71* (Nov. 2003).

10 In the past, it was apparent that some brokers and investors did not fully understand important aspects of these features. For instance, "although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds." *NASD Notice to Members 99-35* (May 1999). *See also NYSE Information Memo 05-54* (Aug. 11, 2005) ("A customer of advanced years might lack the actuarial expectations necessary for a deferred variable annuity to yield its benefit of income shelter versus costs, and his or her lower tax bracket might render such benefits marginal or negative.").

11 Rule 2821(b)(1)(A)(iii).

12 *Id.*

13 Rule 2821(b)(1)(B).

14 FINRA generally would view asking customers whether they had an exchange at another broker-dealer within 36 months to be a "reasonable effort" in this context.

15 Rule 2821(b)(2).

## Endnotes (cont'd)

16 Rule 2821(c).

17 SEC Order Granting Exemption to Broker-Dealers from Requirements in Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks (Exemption Order), Securities Exchange Act Release No. 56376 (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007).

18 *See* Securities Exchange Act Release No. 31511 (Nov. 24, 1992) (stating that a firm shall not be deemed to receive funds if checks are payable to an entity other than itself—such as to another broker-dealer or escrow agent—and the firm promptly forwards such funds to the third party).

19 *Id.*, note 11, and 17 CFR §240.15c3-1(c)(9). The SEC has extended this definition to SEC Rule 15c3-3(k). *See* NYSE's SEC Rule Interpretations Handbook, at 15c3-3(k)(2)(ii)/015.

20 Exemption Order, *supra* note 17.

21 Several commenters have asked, in the case where a captive broker-dealer shares office space and/or employees with the insurance company, whether, in advance of the broker-dealer's principal approval of the transaction, the customer's funds could be deposited in an account at the insurance company and administration of the issuance processing could begin. The rule does not permit depositing the customer's funds in an account at the insurance company prior to completion of principal review. The rule, however, does not prohibit using the information required for principal review and approval in aid of the issuance process. For instance, the rule generally does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, *i.e.*, paper or electronic) that the insurer uses for the issuance process, provided that no further steps are taken in the issuance process.

22 Rule 2821(c).

23 One commenter asked whether Rule 2821 applies to an issuer's direct sale of a deferred variable annuity to a customer without any involvement of a broker-dealer or persons associated with a broker-dealer. FINRA's rules apply only to member broker-dealers and their associated persons. FINRA notes, however, that the determination of whether an entity should be registered as a broker-dealer rests with the SEC.

24 *See* Rule 2821(d).

25 *Id.* (emphasis added). FINRA notes that Rule 2821(d)(1) focuses on whether an *associated person* has effected an inappropriate number of exchanges, while Rule 2821(b)(1)(B)(iii) focuses on whether a particular *customer* has had another exchange within a 36-month period.

26 *See* Rule 2821(e).

27 The firm also would need to comply with applicable requirements of NASD Rule 3110 and SEC Rules 17a-3 and 17a-4 and interpretations thereof.

## ATTACHMENT A

New language is underlined.

* * * * *

### 2821. Members' Responsibilities Regarding Deferred Variable Annuities

**(a) General Considerations**

**(1) Application**

This Rule applies to the purchase or exchange of a deferred variable annuity and the subaccount allocations. This Rule does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the Securities Exchange Act of 1934 or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

**(2) Creation, Storage, and Transmission of Documents**

For purposes of this Rule, documents may be created, stored, and transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

**(3) Definitions**

For purposes of this Rule, the term "registered principal" shall mean a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24), or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

**(b) Recommendation Requirements**

(1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with Rule 2310 and, in particular, that there is a reasonable basis to believe that

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by subparagraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by subparagraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer's account has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

**(c) Principal Review and Approval**

Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after the customer signs the application, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity. Subject to the exception in this paragraph, and treating all transactions as if they have been recommended for purposes of this principal review, a registered principal shall approve the transaction only if the registered principal has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule. Notwithstanding the foregoing, a registered principal may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and approved, rejected, or authorized the transaction.

(d) Supervisory Procedures

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012, 3013, and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

(e) Training

Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in subparagraph (b)(1)(A)(i) of this Rule.

* * * * *

## ATTACHMENT B

# Division of Responsibilities Outline under Rule 2821 (Deferred Variable Annuities)

*This outline highlights the general division of responsibility among registered representatives, registered principals and firms under Rule 2821. Please be aware that, in the case of any misunderstanding, the rule language prevails. In addition, please note that your firm may have additional policies and procedures that registered representatives and principals must follow.*

## Registered Representatives (RRs),

➢ **when recommending either a purchase or an exchange of a deferred variable annuity, must**

1. reasonably try to obtain and consider information about the customer, including
   a. age
   b. annual income
   c. financial situation and needs
   d. investment experience
   e. investment objectives
   f. intended use of the deferred variable annuity
   g. investment time horizon
   h. existing assets (*e.g.*, investment and life insurance holdings)
   i. liquidity needs
   j. liquid net worth
   k. risk tolerance
   l. tax status

2. reasonably believe that the purchase or exchange is suitable, based on a variety of factors, including
   a. the customer has been informed, in general terms, of the material features of deferred variable annuities, such as
      - potential surrender period and surrender charge
      - potential tax penalty components
      - mortality and expense fees
      - charges for and features of enhanced riders, if any
      - insurance and investment
      - market risk
   b. the customer would benefit from one or more features of deferred variable annuities, such as
      - tax-deferred growth
      - annuitization
      - a death or living benefit
   c. the particular deferred variable annuity as a whole, underlying subaccounts, and riders and similar product enhancements, if any, are suitable

3. document and sign his or her determinations, providing the principal assigned to review the transaction with enough information to assess compliance with the rule

➢ **when determining suitability for a recommended *exchange* of a deferred variable annuity, also must consider whether the customer**

1. would incur a surrender charge, be subject to a new surrender period, lose existing benefits or be subject to increased fees or charges
2. would benefit from product enhancements and improvements
3. has exchanged a deferred variable annuity within the last 36 months

## Registered Principals

1. must review each purchase and exchange and determine whether to approve the transaction before sending the customer's application to the insurer for processing, but no later than seven business days after the customer has signed the application
2. must treat all transactions as if they have been recommended for purposes of review
3. can approve the transaction only if he or she reasonably believes that it is suitable based on the factors that RRs must consider for recommended transactions
4. may authorize the processing of an unsuitable transaction if the principal determines both that
   a. the transaction was not recommended and
   b. the customer, after being told why the principal found it to be unsuitable, has stated that he or she wants to proceed with the purchase or exchange
5. must document and sign all determinations

## Broker-Dealer Firms,

➢ **with respect to supervisory procedures, must**

1. have written supervisory procedures reasonably designed to achieve compliance with the rule
2. have surveillance procedures to identify which, if any, of their RRs have a rate of effecting exchanges that raises a question as to whether those exchanges comply with this or other rules
3. have procedures to address and correct exchanges that do not comply with this or other rules

➢ **with respect to training, must**

1. create training programs on deferred variable annuities for RRs who sell, and for principals who review transactions in, these products

# EXHIBIT C

# NASD Notice to Members 99-35

## The NASD Reminds Members Of Their Responsibilities Regarding The Sales Of Variable Annuities

### Suggested Routing

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

### Executive Summary

National Association of Securities Dealers, Inc. (NASD®) Rule 3010 requires each member to establish and maintain a system to supervise the activities of each registered representative and associated person in order to achieve compliance with the securities laws, regulations, and NASD rules. Variable life insurance and variable annuities are securities and their distribution is subject to NASD rules. This *Notice* focuses on deferred variable annuity sales and provides a set of guidelines that are intended to assist members in developing appropriate procedures relating to variable annuity sales to customers.

The guidelines identify areas of concern that NASD Regulation, Inc. (NASD Regulation®) would expect to be addressed in the procedures of members that offer and sell variable annuities. Although the specific procedures described are not mandatory, members should consider supplementing their procedures to ensure that they will be adequately designed to achieve compliance with legal and regulatory requirements.

Questions concerning this *Notice* may be directed to Thomas M. Selman, Vice President, Investment Companies/Corporate Financing, NASD Regulation, at (240) 386-4533; Lawrence Kosciulek, Assistant Director, Advertising/Investment Companies, NASD Regulation, at (202) 728-8329; or Elliot R. Curzon, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8451.

### Background

A variable annuity is an insurance contract that is subject to regulation under state insurance and securities laws. Although variable annuities offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds: (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that can provide guaranteed income for life.

A customer's premium payments to purchase a variable annuity are allocated to underlying investment portfolios, often termed subaccounts. The variable annuity contract may also include a guaranteed fixed interest subaccount that is part of the general account of the insurer. The general account is composed of the assets of the insurance company issuing the contract. The value of the underlying subaccounts that are not guaranteed will fluctuate in response to market changes and other factors. Because the contract owners assume these investment risks, variable annuities are securities and generally must be registered under the Securities Act of 1933.

The underlying subaccounts that are not guaranteed are funded by a separate account of a life insurance company that, absent an exemption, is required to be registered as an investment company under the Investment Company Act of 1940. Variable annuities assess various fees including fees related to insurance features, *e.g.*, lifetime annuitization and the death benefit. The fees are typically deducted from customer assets in the separate account.

A distributor of variable annuity contracts to individuals is required to register as a broker/dealer under the Securities Exchange Act of 1934 and become a member of the NASD. The distribution of variable annuity contracts is subject to NASD rules.

Typically, variable annuities are designed to be long-term

investments for retirement. Withdrawals before a customer reaches the age of 59 1/2 are generally subject to a 10 percent penalty under the Internal Revenue Code. In addition, many variable annuities assess surrender charges for withdrawals within a specified time period after purchase.

Generally, variable annuities have two phases: the "accumulation" phase when customer contributions are allocated among the underlying investment options and earnings accumulate; and the "distribution" phase when the customer withdraws money, typically as a lump-sum or through various annuity payment options.

The myriad features of variable insurance products make the suitability analysis required under NASD rules particularly complex. NASD Regulation has addressed suitability issues in variable insurance products sales in *Notice to Members 96-86*. In that *Notice*, NASD Regulation stated that when recommending variable annuities or variable life insurance, the member and its registered representatives are required to make reasonable efforts to obtain information concerning the customer's financial and tax status, investment objectives, and such information used or considered reasonable in making recommendations to the customer.[1] In addition, a recent NASD disciplinary action discussed members' responsibilities under Rule 2310 (Suitability Rule) as they apply to the sale of variable life insurance. (*See* In the Matter of DBCC No. 8 v. Miguel Angel Cruz.[2])

## Discussion

NASD Regulation has developed the following guidelines that represent a compilation of industry practices in the supervision of the sale of variable annuities. The guidelines do not mandate any specific procedure. Rather, they are designed to assist members in developing appropriate procedures relating to variable annuity sales practices. The guidelines are not comprehensive and are not intended as a substitute for the member's responsibilities under NASD Rule 3010. Moreover, the Suitability Rule requires an associated person of a member to make an independent determination whether an investment is suitable for a particular customer, taking into account the customer's investment objectives and financial needs.

### Customer Information

The Suitability Rule requires members and their registered representatives to make reasonable efforts to obtain information concerning a customer's financial and tax status, investment objectives, and such other information used or considered in making recommendations to the customer.

**1.** When recommending a variable annuity, members and their registered representatives should make reasonable efforts to obtain comprehensive customer information, including the customer's occupation, marital status, age, number of dependents, investment objectives, risk tolerance, tax status, previous investment experience, liquid net worth, other investments and savings, and annual income. Retention of this customer information can be made in conjunction with the maintenance of basic customer account information that is required in NASD Rule 3110.

**2.** A registered representative should discuss all relevant facts with the customer, including liquidity issues such as potential surrender charges and the Internal Revenue Service (IRS) penalty; fees, including mortality and expense charges, administrative charges, and investment advisory fees; any applicable state and local government premium taxes; and market risk.

**3.** The registered representative should seek to ensure that the variable annuity application and any other information provided by the customer to the member is complete and accurate, and promptly forwarded to a registered principal for review.

**4.** When a variable annuity transaction is recommended to a customer, the registered representative and a registered principal should review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying subaccounts recommended to the customer are suitable. The registered principal should compare the information in the account application with other relevant information sources, *e.g.*, an account information form, to check for apparent accuracy and consistency prior to approving the transaction.

### Product Information

**5.** The registered representative should have a thorough knowledge of the specifications of each variable annuity that is recommended, including the death benefit, fees and expenses, subaccount choices, special features, withdrawal privileges, and tax treatment.

**6.** To the extent practical, a current prospectus should be given to the customer when a variable annuity is recommended. Prospectus information about important factors, such as fees and expenses and the illiquidity of the product, should be discussed with the customer.

**7.** Under NASD Rule 2210, the registered representative may only use sales material that is approved by a registered principal of the member.

## Liquidity And Earnings Accrual

Lack of liquidity, which may be caused by surrender charges or penalties for early withdrawal under the Internal Revenue Code, may make a variable annuity an unsuitable investment for customers who have short-term investment objectives. Moreover, although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds.

**8.** The registered representative should inquire about whether the customer has a long-term investment objective and typically should recommend a variable annuity only if the answer to that question, with consideration of other product attributes, is affirmative. In general, the registered representative should make sure that the customer understands the effect of surrender charges on redemptions and that a withdrawal prior to the age of 59 1/2 could result in a withdrawal tax penalty. In addition, the registered representative should make sure that customers who are 59 1/2 or older are informed when surrender charges apply to withdrawals.

**9.** The member should develop special procedures to screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a specific age. Based on certain contract features, some customers of advanced age may be unsuitable for a variable annuity investment.

## Income, Net Worth, And Contract Size Thresholds

**10.** Members should establish procedures to require a principal's careful review of variable annuity investments that exceed a stated percentage of the customer's net worth, and any contract in which a customer is investing more than a stated dollar amount.

## Investment In Tax Qualified Accounts

Some tax-qualified retirement plans (*e.g.*, 401(k) plans) provide customers with an option to make investment choices only among several variable annuities. While these variable annuities provide most of the same benefits to investors as variable annuities offered outside of a tax-qualified retirement plan, they do not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself.

**11.** When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (*e.g.*, 401(k) plan, IRA), the registered representative should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.

**12.** A member should conduct an especially comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements.

## Variable Annuity Replacements

**13.** The member firm may decide to develop an exchange or replacement analysis document or utilize an existing form authorized by a state insurance commission or other regulatory agency. If such a document is used, then (consistent with the requirements of various states) it should be completed for all variable annuity replacements and should include an explanation of the benefits of replacing one contract for another variable contract. The document also should be signed by the customer, the registered representative, and the registered principal.

**14.** The registered representative and the registered principal should determine, based on the information provided by the customer and their own knowledge of the product features, that replacing the existing contract with a new contract is suitable for the customer. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges.

**15.** The member firm should consider developing compliance systems, such as computer programs, when available, that can monitor and identify those registered representatives whose clients have a particularly high rate of variable annuity replacements or rollovers. These compliance systems should provide the firm with "red flags" that

the firm can investigate to determine whether some of these replacements are unsuitable.

**16.** A retail member should adopt other measures reasonably designed to ensure that replacement sales activity by its registered representatives complies with NASD rules. Members that "wholesale" variable annuities are reminded that they are also subject to NASD rules, and that they should avoid marketing strategies that are designed primarily to encourage inappropriate replacement sales. Upon reasonable request and to the extent practical, wholesale members should assist retail broker/dealers in monitoring the replacement activity of their customers.

## Endnote

[1]*Notice to Members 96-86* also listed specific factors that could be considered when recommending variable annuities and variable life insurance contracts. These factors are:

- a representation by a customer that his or her life insurance needs were already met;
- the customer's express preference for an investment other than an insurance product, the customer's inability to appreciate fully how much of the purchase payment or premium is allocated to cover insurance or their costs, and a customer's ability to understand the complexity of variable products generally;
- the customer's willingness to invest a set amount on a yearly basis;
- the customer's need for liquidity and short-term investment;
- the customer's immediate need for retirement income; and
- the customer's investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

[2]Complaint No. C8A930048 (NBCC Oct. 31, 1997)

# EXHIBIT D

**INFORMATIONAL**

# Online Suitability

## Suitability Rule And Online Communications

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- 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] 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.

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 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 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":

- 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":

- 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 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]
- 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.

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.

## Endnotes

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").

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.

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 (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.").

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.

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).

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.

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.

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.

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.

**INFORMATIONAL**

# Online Suitability

## Suitability Rule And Online Communications

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- 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] 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.

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.

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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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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 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]

- 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.
- 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.

### 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.

## Endnotes

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").

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.

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 (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.").

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.

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).

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.

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.

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.

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.