

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54217; File No. SR-NASD-2006-011)

July 26, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving a Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Principal Pre-Use Approval of Member Correspondence to 25 or More Existing Retail Customers Within a 30 Calendar-Day Period

I. Introduction

On January 27, 2006, the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NASD Rule 2211 (“Institutional Sales Material and Correspondence”) to require principal pre-use approval of member correspondence to 25 or more existing retail customers within a 30 calendar-day period. On February 13, 2006, NASD filed Amendment No. 1 to the proposed rule change. The proposed rule change was published for comment in the Federal Register on February 28, 2006.³ The Commission received five comments on the proposal, as amended.⁴ On June 29, 2006, NASD submitted a response to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 53333 (February 17, 2006), 71 FR 10090.

⁴ See comment letters to Nancy M. Morris, Secretary, Commission, from Caroline B. Austin, CEO, Evolve Securities, Inc., dated March 7, 2006 (“Evolve Letter”); Dorothy M. Donohue, Associate Counsel, Investment Company Institute, dated March 17, 2006 (“ICI Letter”); Tim Kelly, Partner, Field Supervision, Edward D. Jones & Co., LP, dated March 20, 2006 (“Edward D. Jones Letter”); Jack R. Handy, Jr., President and CEO, Financial Network Investment Corporation, dated March 21, 2006 (“FNIC Letter”); and Dale E. Brown, CAE, Executive Director & CEO, Financial Services Institute, dated March 21, 2006 (“FSI Letter”).

comments⁵ and filed Amendment No. 2 to the proposed rule change.⁶ This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

In 2003, as part of NASD's modernization of its advertising rules, the SEC approved the adoption of NASD Rule 2211, which included an amended definition of "correspondence."⁷ The definition of correspondence includes any written letter or electronic mail message distributed by a member to one or more of its existing retail customers and to fewer than 25 prospective retail customers within a 30 calendar-day period.⁸ Previously, "correspondence" included any written or electronic communication prepared for delivery to a single current or prospective customer, and not for dissemination to multiple customers or the general public.

The definition of correspondence is significant in several respects. Firms generally are not required to have a registered principal approve correspondence prior to use, nor are they required to file correspondence with the NASD Advertising Regulation Department ("Department").⁹ In addition, correspondence is subject to fewer content restrictions than

⁵ See letter from Philip A. Shaikun, Associate Vice President and Associate General Counsel, NASD, to Katherine England, Assistant Director, Division, Commission, dated June 29, 2006 ("NASD Response Letter").

⁶ Amendment No. 2 made clarifying changes to the proposed rule text, thus it is a technical amendment and is not subject to notice and comment.

⁷ See Securities Exchange Act Release No. 47820 (May 9, 2003), 68 FR 27116 (May 19, 2003).

⁸ NASD has clarified that, for purposes of its rules governing member communications with the public, it views instant messaging in the same manner in which it views traditional electronic mail messages. Accordingly, instant messaging may qualify as correspondence or sales literature, depending upon the facts and circumstances. See Notice to Members 03-33 (July 2003).

⁹ NASD Rule 3010(d)(2) requires each member to develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and

advertisements and sales literature. NASD noted that it amended the definition in order to provide firms with more flexibility regarding the supervision of certain emails and form letters. NASD further noted, however, that it understands that many firms continue to require registered principal pre-use approval of some correspondence.

Proposed Amendment

NASD indicated that it has found that some member correspondence to multiple existing customers raises the same regulatory concerns as member advertisements and sales literature. However, members are not currently required to have such correspondence approved by a principal prior to use or to file it with the Department. As a result, NASD is proposing to amend Rule 2211 to require registered principal pre-use approval of any non-clerical correspondence¹⁰ sent to 25 or more existing retail customers within any 30 calendar-day period. NASD stated that non-clerical correspondence with such a wide distribution often will constitute a solicitation to purchase or sell a security or to use a brokerage service.

NASD is not proposing to require that this correspondence be filed with the Department or that it be subject to all of the content standards of the advertising rules. A firm may, however, choose to file this correspondence with the Department to better ensure that it

outgoing correspondence with the public relating to its investment banking or securities business. Where such procedures do not require review of all correspondence prior to use or distribution, they must provide for the education and training of associated persons as to the firm's procedures governing correspondence, documentation of the education and training, and surveillance and follow-up to ensure that the procedures are implemented and adhered to.

¹⁰ In Amendment No. 2, in response to comments on the original proposal, NASD clarified that registered principal pre-use approval would only be required for correspondence that "makes any financial or investment recommendation or otherwise promotes a product or service of the member."

complies with applicable standards, particularly when the correspondence promotes the firm's products or services.

NASD indicated that it will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 30 days following Commission approval. The effective date will be 90 days following publication of the Notice to Members announcing Commission approval.

III. Summary of Comments and NASD's Response

As noted above, the Commission received five comments on the proposal,¹¹ to which NASD has filed a response letter.¹² Two commenters supported the proposal, without reservation.¹³ One of these commenters, in expressing its "unqualified support" for the proposal, noted that the proposal is consistent with recently-announced NASD communications policies, as well as the policies of other self-regulatory organizations, and that the proposal gives firms discretion with regard to their internal supervisory procedures "without sacrificing customer protections."¹⁴ The other commenter commended NASD for furthering the interests of investors without being unnecessarily burdensome.¹⁵

Three commenters expressed reservations regarding the proposal.¹⁶ Two of the commenters asserted that NASD has not provided sufficient justification for the proposal, which

¹¹ See supra note 4.

¹² See NASD Response Letter, supra note 5.

¹³ See Edward D. Jones Letter and ICI Letter, supra note 4.

¹⁴ See Edward D. Jones Letter, supra note 4.

¹⁵ See ICI Letter, supra note 4.

¹⁶ See Evolve Letter, FNIC Letter and FSI Letter, supra note 4.

they believe will impose significant burdens on the industry.¹⁷ These commenters argued that NASD should provide data to document the pervasiveness of the problem it is attempting to address by adopting the proposed amendments.¹⁸ One of these commenters pointed out that the current rules seem sufficient to detect and prevent abuse.¹⁹ The same commenter argued that the proposal would interfere with members' ability to allocate compliance resources efficiently, which could lead to, among other things, delay of important client communications or draining of assets that could be directed towards areas of greater compliance concern.²⁰ The other commenter argued that NASD did not properly analyze the resulting burdens of the proposal on the industry and has provided no explanation of what occurred in the relatively short period since NASD Rule 2211 was adopted to justify the proposed change.²¹ Another commenter stated that the proposal is not in and of itself necessarily a bad idea or outrageously burdensome but that the Commission should examine the body of rules collectively, rather than individual rules, in order to understand the true burden of compliance.²² Two commenters suggested that the proposed pre-use approval only be required for firms that are found to display "risky broker/dealer

¹⁷ See FNIC Letter and FSI Letter, supra note 4.

¹⁸ Id.

¹⁹ See FSI Letter, supra note 4. This commenter also argued that NASD's assertion that many firms already require principal pre-use approval of correspondence is unsupported and noted that many of its members do not currently require principal pre-use approval of correspondence. Id.

²⁰ Id.

²¹ See FNIC Letter, supra note 4. This commenter further noted that the lack of justification for the proposal is especially troubling given that NASD is not proposing to require members to submit correspondence covered by the proposed rule to the Department. The commenter argued that the policy is inconsistent with NASD's assertion that such correspondence raises the same issues as advertisements and sales literature. Id.

²² See Evolve Letter, supra note 4.

behavior”²³ or to violate the current requirements.²⁴ One of these commenters asserted that principal pre-use approval burdens “good people” who follow the rules without changing the behavior of “bad people.”²⁵ The other commenter suggested a 12-month pre-use approval requirement for firms violating the current requirements, which would then terminate unless the firm committed further violations, at which point NASD could impose more severe sanctions.²⁶

In its response letter, NASD reiterated that it believes that correspondence sent to large numbers of existing retail customers, particularly correspondence intended to promote a member’s products or services, raises many of the same issues as advertising and sales literature, which is subject to approval.²⁷ NASD argued that the commenters did not show why the risks raised by such correspondence differ from those raised by advertisements or sales literature. Furthermore, NASD disputed assertions that the problem must be pervasive in order for NASD to adopt new rules; rather, it argued, a better approach is to try to anticipate problems before they occur.

Two commenters pointed out problems with pre-use approval of email.²⁸ One argued

²³ Id. This commenter further suggested that corrective behavior could be implemented in specific divisions of larger firms, rather than the entire firm. Id.

²⁴ See FSI Letter, supra note 4.

²⁵ See Evolve Letter, supra note 4.

²⁶ See FSI Letter, supra note 4.

²⁷ The Commission notes that advertising and sales literature are subject to pre-use approval.

²⁸ See FNIC Letter and FSI Letter, supra note 4.

that, as a result of pre-use approval, financial advisors will not be able to quickly communicate critical information to their clients.²⁹ The commenter further argued that the proposal, if implemented, could lead its members to curtail the use of email by registered representatives, in order to avoid the expense of complying with the proposal.³⁰ The other commenter indicated that members might have to require pre-use approval of all email messages since they will not be able to easily monitor which messages require pre-use approval.³¹

In response, NASD stated that such arguments were “unpersuasive” in that the commenters suggested that current NASD rules do not require principal pre-use approval of any emails. As NASD noted, the current rules require pre-use approval of emails sent to 25 or more prospective retail customers within a 30 calendar-day period, since such emails are considered sales literature. Therefore, NASD noted, the proposed rule change would merely add to the categories of email requiring pre-use approval.

One commenter also claimed that the exclusion for clerical or ministerial correspondence “lacks clarity” and that NASD should make clear whether its intent is to have the proposal relate to correspondence addressing securities products.³² This commenter noted that if the exclusion is not clear, all correspondence will have to be pre-approved, which could create issues for making timely communications.³³

²⁹ See FSI Letter, supra note 4.

³⁰ Id.

³¹ See FNIC Letter, supra note 4.

³² Id.

³³ Id.

In its response letter, NASD indicated that it is amending the proposed rule change to require pre-use approval of correspondence only if it “makes any financial or investment recommendation or otherwise promotes a product or service of the member,”³⁴ rather than requiring pre-use approval of correspondence that is “not solely and exclusively clerical or ministerial in nature.” NASD further clarified that principal pre-use approval would not be required for correspondence concerning clerical or ministerial matters, such as dividend notices or changes in office hours, or for correspondence that does not promote a product or service of the member, such as emails including only market commentary. NASD did note, however, that all correspondence must be supervised by members in accordance with NASD Rule 3010(d).

IV. Discussion

After careful consideration of the proposed rule change, the comment letters and NASD’s response to the comments, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities association.³⁵ Specifically, the Commission believes that the proposal is consistent with Section 15A(b)(6) of the Act³⁶ in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest by requiring additional supervision of correspondence by broker-dealers. The Commission notes that NASD has represented that many firms require registered principal pre-use approval of some correspondence, even though not required by NASD

³⁴ See Amendment No. 2.

³⁵ In approving this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁶ 15 U.S.C. 78q-3(b)(6).

rules. In addition, NASD carved out correspondence that does not make any financial or investment recommendation or otherwise promote a product or service of the member from coverage of the rule and did not require correspondence covered by the rule to be filed with the Department. The Commission believes that requiring pre-use approval by a principal of correspondence sent to 25 or more existing retail customers within any 30 calendar-day period appropriately balances the needs of members to contact existing customers without being unduly burdened against the goal of having communications with retail customers that are fair and balanced.

The Commission is not persuaded by the commenters' arguments that pre-use approval of emails is not workable given that pre-use approval is already required for certain emails.³⁷ The Commission commends NASD for attempting to address problems with correspondence, rather than waiting for additional inappropriate materials to reach retail customers. Finally, the Commission believes that NASD's proposed amendment to the rule text adequately addresses concerns that the proposed rule change lacks clarity.

³⁷ For example, emails sent to 25 or more prospective retail customers within a 30 calendar-day period currently require principal pre-use approval. See NASD Response Letter, supra note 5.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁸ that the proposed rule change (SR-NASD-2006-011), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁹

Nancy M. Morris
Secretary

³⁸

Id.

³⁹

17 CFR 200.30-3(a)(12).