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*SUBMITTED VIA EMAIL AND OVERNIGHT MAIL*

Mr. Jonathan G. Katz  
Secretary  
United States Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

**Re: NASD Proposed Rule Change Relating to Proposed Interpretive Material  
Regarding the Use of Investment Analysis Tools, File No. SR-NASD-2003-13**

Dear Mr. Katz:

Charles Schwab & Co., Inc. (“Schwab”) appreciates this opportunity to comment on the above-captioned proposed Interpretive Material (“IM”) regarding the regulation of online and other investment analysis tools (“investment analysis tools”).<sup>1</sup> As demonstrated by the fifty-six comment letters the NASD received last year, this is an important rule proposal that warrants careful review. It has significant implications for broker-dealers that provide or want to provide sophisticated tools to assist their clients in making informed investment decisions. We appreciate the consideration of our comment letter and others than may be filed outside the limited 21-day comment period.<sup>2</sup>

Schwab has over eight million account holders, including over four million that have access to the customer center on our Web site. Our technological tools that help our self-directed clients allocate assets, analyze portfolios, and plan future investments are of vital importance. Schwab generally believes that an updated interpretation of NASD Rule 2210(d)(2)(N) has the potential to clarify application of this longstanding rule to current tool technology and portfolio analysis techniques. It also has the potential to level the playing field for individual investors and to enable them to access tools through their brokers that are already widely available through investment advisers and unregulated Web sites.

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<sup>1</sup> Release No. 34-47590 (March 28, 2003), 68 *Fed. Reg.* 16325 (April 3, 2003).

<sup>2</sup> We were surprised by the limited notice and comment period that was provided. Because of this IM’s importance, Schwab believes the 21-day comment period is too short for this matter to allow for adequate review and comment by interested parties. To give careful consideration of all comment letters, including those that may arrive “late,” we suggest that the Commission seek the NASD’s consent to expand the time period for final Commission action beyond the standard 35 days.

We appreciate that the NASD has made a number of important revisions to the IM based on Schwab's comments, and those of other firms, following its initial publication in a notice to members last year.<sup>3</sup> Nonetheless, Schwab remains concerned that the proposed rule change is still confusing and too cumbersome to be effective. Our comments below ask the NASD and Commission to:

- (1) revise the definition of investment analysis tools to focus on those tools that project the likely performance of specific recommended securities or mutual funds, thereby addressing the concern the rule seeks to address - a prediction or projection that paints an unrealistic picture of the performance of a security recommended by a broker;
- (2) modify some of the particular disclosure and other requirements in section (c) of the IM, as specified below; and
- (3) eliminate the 30-day pre-filing and approval requirement as an unnecessary and costly burden.

#### **1. Definition of "Investment Analysis Tool."**

We are encouraged by the changes to the IM, modifying the NASD's initial proposal that appeared to prohibit a broad range of investment tools, including educational investment tools already in use, and historically not prohibited by the NASD. However, it is still not clear what tools are covered by the prohibition in Rule 2210(d)(2)(N) and what tools are covered by the proposed exception in IM-2210-6.

The clarifications in the proposing release about the purpose of the IM and which tools are not covered by the IM's prescriptive text and therefore are already permissible under existing Rule 2210(d) generally, are not fully reflected in the proposed definition of "investment analysis tool." For example, the NASD's stated purpose in the proposing release is "to allow NASD member firms to use certain investment analysis tools that show the probability that *investing in certain securities or mutual funds may produce a desired result.*"<sup>4</sup> This is consistent with the original purpose of Rule 2210(d)(2)(N): to protect against unwarranted or misleading communications to the public that predict or project investment results.

Excluded from that purpose are tools that exist today that analyze a self-directed client's current portfolio in light of a client-given goal (e.g., retirement) and that do not make any investment recommendations. Indeed, several of the proposed investment analysis tool disclosure requirements only make sense if the tool results in or analyzes

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<sup>3</sup> See Letter from Christopher P. Gilkerson, Charles Schwab & Co., Inc. to Barbara Z. Sweeney, NASD (dated Oct. 1, 2002).

<sup>4</sup> 68 *Fed. Reg.* at 16326.

investment recommendations.<sup>5</sup> Also excluded from the definition should be tools that are currently used internally by registered representatives to make recommendations to their clients, where the tool itself is not client-facing. To harmonize the stated purpose of, and exclusions from, the IM with the definition of investment analysis tool, and to make clear what tools are subject to the new exception, Schwab recommends that the definition be revised as follows (with text additions in bold):

For purposes of this Interpretive Material and any interpretation thereof, an “investment analysis tool” is an ~~“interactive technological tool that~~ **an investor interacts with that** produces simulations and statistical analyses that present a **probability or** range of probabilities that **investing in recommended securities (including mutual funds) might produce** various investment outcomes, ~~might occur~~ thereby serving as an additional resource to investors on the evaluation of the potential risks and returns on **those** particular investments.

Failure to make the above amendments will lead to confusion and inconsistency between past and current interpretations and practices under different parts of Rule 2210(d). In currently making planning tools (that do not result in recommending particular investments) available to their clients, many members including Schwab have relied on language in Rule 2210(d)(2)(C) that allows “forecasts of future events” provided that forecasts are not “unwarranted” and have a reasonable basis. Outside of the investment analysis tool context, members for years have made predictions and forecasts - including price targets that rely on probability analysis – in the research that they offer to their clients. The final IM should make the above changes to the definition to refrain from upsetting settled expectations.

## 2. Particular Requirements.

Proposed IM-2210-6 is an improvement over the NASD’s initial draft. However, the provisions are still not flexible enough. The requirements under subsection (c) should be amended to avoid mandating particular disclosures and particular language that must be used. The one-size-fits-all approach might not be appropriate or may be confusing in relation to certain kinds of tools. The requirements also should avoid the implication of cumbersome and unnecessary “audit” and “review” requirements. Below are Schwab’s specific suggestions for modifications.

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<sup>5</sup> See proposed IM-2210-6(c)(6) (“the member describes the universe of investments considered in the analysis, and explains how the tool determines which securities to select, discloses if the tool favors certain securities and, if so, explains the reasons for the selectivity ....”).

A. IM-2210-6(c)(1) – Present a “Range of Probabilities”

This proposed section would require that a particular tool “[present] a range of probabilities that various outcomes might occur.” While Schwab agrees that where a range of probabilities are presented, a fair presentation of the range should be provided, there are tools whose purpose and use do not include presenting a range of probabilities. For example, a tool might analyze, through simulations, growth of investment principal at a user-defined rate over a user-defined time horizon. The tool’s result shows the probability of meeting the user-defined assumptions and goals. For such a tool, providing “a range of probabilities” is not directly applicable and would require unnecessary and confusing information to be provided as part of the tool.<sup>6</sup>

B. IM-2210-6(c)(3) – Use a “Mathematical Process that Can Be Audited and Reviewed”

The final IM should make clear that this requirement does not mean members must archive for later reproduction the hundreds or thousands of mathematical calculations of each tool session or provide for or accommodate a costly and time consuming “audit” in order to comply with the IM. Schwab believes that the words “that can be audited and reviewed” should be deleted and replaced with the words “that is documented.” The final IM should make clear that it is only the general mathematical process itself that must be documented and not the specific calculations generated for any specific application of the tool.<sup>7</sup>

C. IM-2210-6(d) – Disclosures and Other Required Information “Must Be Written, Clear, and Prominent”

Schwab has no objection to “clear and prominent” disclosures as a basic principle, but the final IM should indicate that members have the discretion on where to place those clear and prominent disclosures, as part of the tool’s interactive process and/or on any report that provides the tool’s result. Also, given that this is a rule about electronic investment analysis tools, the language of the rule should be amended expressly to permit “clear and prominent written or electronic disclosures.”

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<sup>6</sup> For the same reason, the last sentence of proposed IM-2210-6(c)(7) should also be modified to allow disclosure that reflects presentation of one probability, instead of a range. Similarly, under proposed IM-2210-6(c)(2), the requirement ought to be only that the tool’s results be provided in a “fair and balanced representation” of the possible investment outcomes, as it may not make sense in the context of a particular tool to require “at a minimum the ‘upside,’ ‘downside,’ and ‘median’ projections of estimated outcomes.” 68 *Fe. Reg.* at 16326 n.4.

<sup>7</sup> In any “non-merit” review by the NASD, see Part 3 of this comment letter, a member should not have to file a written copy of the mathematical process documentation, or justify or go to any lengths to explain to the NASD Advertising Regulation Department the complex mathematical method used by the tool. A requirement that a member file with the NASD a written copy of a proprietary model would expose the member to significant intellectual property risks.

### **3. 30-Day Pre-Use Filing of Tools with NASD Advertising Regulation Department.**

The Release would impose a new requirement that members must file investment analysis tools pre-use with the Advertising Regulation Department. Schwab opposes this requirement as burdensome, and believes that a pre-use filing requirement is unnecessary and unwarranted.

With the exception of certain mutual fund advertising materials, a pre-use filing requirement is contrary to the approach taken with respect to virtually every other communication with the public, including the new disclosures relating to research reports and research analysts, a much more controversial area than investment analysis tools. There is no justification for singling-out broker-dealer investment analysis tools. A pre-use filing obligation seems to assume that such tools are communications with the public that are inherently suspect or problematic. We have seen no evidence of that, and none has been provided by the NASD.<sup>8</sup> Moreover, it places broker-dealers at a competitive disadvantage given that investment advisers, mutual funds, and unregulated financial portals on the Web have no such pre-use approval process for their investment analysis tools.

The additional burden imposed by a pre-use filing requirement, and the sometimes protracted negotiation process that could take place with the NASD staff, should not be underestimated. Sophisticated tools may be over a year in the making and require the investment of hundreds of thousands of dollars. To insert the NASD Advertising Regulation Department into that development cycle could result in costly delays in the launch of new valuable and proprietary tools that benefit investors.

On its face, the draft IM appears to be reserving substantial authority and discretion to withhold approval based on more than whether the right disclosures appear in a clear and prominent location or whether any exaggerated claims are made. The draft IM provides:

“If the Department request changes to the investment analysis tool, written-report template or sales material, the member may not offer or use the tool until all changes specified by the Department have been made by the member and approved by the Department.”<sup>9</sup>

That is a seemingly broad grant of pre-use review and approval authority which suggests multiple rounds of 30-day review periods. In contrast is the NASD’s “statement of purpose” in the Federal Register notice, which is much more modest, indicating that “the

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<sup>8</sup> Despite the fact that many firms commented on the absence of any demonstrated need for the pre-use filing requirement, the NASD’s “Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others” failed to address those comments. *See* 68 *Fed. Reg.* at 16327.

<sup>9</sup> Proposed IM-2210-6(a).

review and approval are not merit-based, but rather focus on whether the member has complied with the disclosure requirements and other requirements of NASD Rule 2210.”

Given the NASD’s stated goal of non-merit based disclosure review, Schwab believes that it is unnecessary to interject the NASD’s advertising group as an uncertain contingency in the investment analysis tool development and launch process. The disclosure requirements, as modified, would be clear enough on their face for members to implement, rendering any prior review unnecessary. NASD review - as is the case with all other communications with the public with certain rare exceptions where abuses have been detected in the past – should be conducted as part of the regular exam process or if any complaints are brought to the NASD’s attention. In the very least the final IM ought to be amended to allow for post-launch filing and to clarify the limited nature of the NASD’s disclosure review.

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Schwab appreciates the opportunity to comment on this important proposal. Please feel free to contact me to discuss the points raised in this comment letter.

Very truly yours,

Christopher P. Gilkerson  
Vice President and Associate General Counsel

Cc: Hon. William H. Donaldson, Chairman, SEC  
Hon. Paul S. Atkins, Commissioner, SEC  
Hon. Roel C. Campos, Commissioner, SEC  
Hon. Cynthia A. Glassman, Commissioner, SEC  
Hon. Harvey J. Goldschmid, Commissioner, SEC  
Annette L. Nazareth, Director, Division of Market Regulation  
Kathy England, Assistant Director, Division of Market Regulation  
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