

April 24, 2003

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

Re: Proposed Rule Change of the National Association of Securities Dealers, Inc.  
Relating to Investment Analysis Tools, File No. SR-NASD-2003-13

Dear Mr. Katz:

Harris Investor Services LLC (“*Harrisdirect*”) appreciates the opportunity to comment on the rule filing by the National Association of Securities Dealers, Inc. (“NASD”)<sup>1</sup> captioned above proposing to regulate online and other investment analysis tools (“Investment Analysis Tools” or “Tools”). *Harrisdirect* has taken an active interest in the NASD proposal, having commented on the Interpretive Material to Rule 2210(d)(2)(N) (“Interpretive Material”) as originally proposed in the NASD’s Notice to Members 02-51 (August 2002), which requested member firm comment. As an online broker-dealer, *Harrisdirect* also has been active in working with various regulatory authorities to facilitate e-commerce initiatives.

While we support the NASD’s broader goals to facilitate the use of Tools by member firms and their customers, *Harrisdirect* strongly disagrees with the NASD’s proposal and its overall regulatory approach. The proposal if adopted would establish a bad and disturbing new policy, that of the non-merit/merit review, and exacerbate conflicts within NASD rules and between NASD and other SRO rules. Therefore, we respectfully request that the SEC deny the proposal.

The inherent problem, unique to the NASD, is that its advertising rules prohibit certain “predictions and projections” but permit “forecasts” of investment results. The NASD staff has apparently interpreted the “prediction and projection” language inconsistently, although there is little published evidence of these interpretations, and has not applied this prohibition to all similar communications with the public. To the surprise of member firms, the NASD announced

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<sup>1</sup> Exchange Act Rel. No. 47590 (Mar. 28, 2003), 68 Fed. Reg. 16325 (Apr. 3, 2003).

in the Notice to Members that it has applied this language to prohibit member use and investor access to Investment Analysis Tools. We understand that this has occurred primarily with respect to new broker-dealer applicants with proposed web sites containing Tools, and who are subject to a *de novo* review of the new web site. Pre-existing broker dealers, such as *Harrisdirect*, have used such Tools for years without a filing/NASD approval process and without an understanding that they violated the rule or caused regulatory or consumer problems.

In the past, the Securities and Exchange Commission (“SEC”) has required that SROs first amend their rules when they are conflicting, confusing and lead to difficulties for or inconsistencies with member firm compliance. We recommended that the SEC return the rule proposal to the NASD with the instruction that it first amend its rules to be internally consistent and consistent with rules of the New York Stock Exchange, Inc. (“NYSE”) and other SROs, which permit projections, predictions and forecasts. Alternatively, the SEC should return the rule to the NASD with the instruction that it adhere to historical and traditional interpretations of the terms “projections, predictions or forecasts,” which prevent exaggerated or unwarranted claims, “guarantees” of investment results or results not properly identified as forecasts.

We have several objections to the NASD rule proposal that we believe raise significant policy and legal questions and that have not been addressed by the NASD.

- The NASD proposal imposes significant and unnecessary burdens on competition. The rule filing does not address this issue as required; therefore, the NASD rule filing is deficient and does not meet legal standards necessary for SEC approval.
- NASD (and NYSE and SEC) advertising rules already authorize use of Investment Analysis Tools that “forecast” investment results. The rule proposal should not be a back door to establish an unnecessary merit review process. The NASD should acknowledge that its rules permit forecasting Tools that do not promise or guarantee a result.
- NASD rules and interpretations contain serious and multiple conflicts and inconsistencies. Consistent with prior SEC directives, the NASD first should harmonize its advertising rules with those of the NYSE.
  - NASD staff interpretations do not prohibit all predictions and projections; for example, predictions and projections are permitted in research reports.
  - NASD rules, and their various references to predictions, projections and forecasts, are internally inconsistent.
  - Some NASD rules use the terms prediction, projection and forecast synonymously, interchangeably and permissibly.
  - The referenced NASD staff interpretations are inconsistent with historical efforts to address simple mutual fund projections and guarantees of results.
  - NASD rules conflict with NYSE rules which permit predictions, projections and forecasts.

- The NASD admittedly is attempting to regulate the advisory and other Tools of registered investment advisers that are made available to member firm customers, an area better left to existing SEC regulations. The NASD also is preventing dual registrants (broker-dealers registered with the SEC as investment advisers) from offering SEC compliant Tools on a united web site without conforming them to additional, subjective NASD standards.
- The Interpretive Material contains many confusing and unnecessary terms and conditions. For example, the scope of the rule is unclear. It contains confusing and conflicting definitions and terms. Its required “disclosures” are confusing and unworkable. These new requirements will cause firms to re-program their existing deployed Tools at significant delay and expense. The proposal does not address whether its rule applies to Tools offered by affiliates, non-affiliates and other third parties. More importantly, the regulatory approach of requiring specific substantive calculations (probability ranges, estimates, projections, etc.), formats and presentations is contrary to the regulatory approach adopted by the SEC and the NASD over the last 20 years.
- Finally, the NASD filing and review requirements create an unprecedented merit review process that is unnecessary, costly and inhibits competition.

#### **UNDUE BURDEN ON COMPETITION - NASD RULE FILING FAILS STATUTORY CRITERIA**

Before approving the rule, the SEC must find that the NASD rule does not impose any undue burden on competition.<sup>2</sup> *Harrisdirect* and many other commenters have argued during the comment process that the proposed rule, and the NASD filing and approval process in particular, would impose significant burdens on competition. In response, the NASD rule filing merely states that “NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the [Exchange] Act, as amended.” The NASD filing contains absolutely no empirical data or other analysis of effects on competition or commentary as to why such an additional rule is “necessary or appropriate” in light of existing NASD and SEC rules. Because the NASD rule filing does not address this issue at all, or respond to commenters’ concerns, the SEC does not have a sufficient basis to approve the proposal.<sup>3</sup>

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<sup>2</sup> Section 15A(b)(9) of the Securities Exchange Act of 1934 (the “Exchange Act”); Section 19(b) of the Exchange Act; Rule 19b-4 promulgated under the Exchange Act.

<sup>3</sup> The rule filing also contains clear deficiencies under Form 19b-4. The general instruction to the form requires an SRO to provide explicit detail of the burdens on competition and an explanation of why the rule is necessary or appropriate. They require SROs to respond in detail to any person who has identified burdens on competition during an SRO comment process. Finally, SRO statements in a rule filing must be sufficiently detailed and specific to support an SEC findings that the proposed rule change does not impose unnecessary or inappropriate burdens on competition. Because the NASD’s rule filing provides no such detail, the SEC cannot make the necessary findings that the proposed rule does not impose burdens on competition, especially in light of the significant burdens identified by commenters.

The proposed Interpretive Material imposes significant burdens on competition between NASD member firms, and between broker-dealers and other financial service providers.

- Only broker-dealers that are NASD members are subject to the rule, including the NASD filing and approval process. Broker-dealers that are members of the NYSE, but are not NASD members, could use the same Tools without being subject to the rule or the NASD filing and approval process.
- Because of the filing and approval requirement, many member firms will have great difficulty competing with each other. Approved Tools will price at a premium or will be locked up under exclusive use contracts. There are a limited number of vendors who are qualified to create sophisticated Tools and there is a limited marketplace for the purchase or licensing of those Tools. A member who has received NASD approval for a Tool will certainly not want the approved Tool deployed by competitors and will make every effort to embargo other use of the Tool. In addition, most Tools are created and licensed by outside vendors, and customized development of such Tools, independent of any review or approval process, takes 6 to 8 months to deploy. Firms typically are required to pay substantial up-front development and monthly license fees that are not refundable. Any NASD required changes resulting from the review process, which are likely, will necessarily involve computer software changes, testing and other costs which can take a significant amount of time, assuming the outside vendor is willing or able to make the changes. Therefore, we anticipate it will take an additional 3-6 months before another member firm can obtain NASD approval to use a competing service. The time and cost necessary for uncertain NASD approval is a significant barrier to entry in a competitive market which simply does not exist today.
- Banks, investment advisers, 401(k) administrators, state 529 plans, financial news web sites, financial planners and other non-regulated entities are not subject to the NASD rule and are free to continue offering a wide range of competing and alternative Tools. Member firms simply will not be able to compete effectively with this large market.
- Member firms that link or refer customers to an investment adviser, bank or other affiliated or non-affiliated third-party which offers a Tool may or may not be subject to the rule, depending on the NASD's subjective whim.<sup>4</sup> The uncertainty in the rule, therefore, may create a range of competitive disadvantages for certain classes of member firms depending on their organizational structure, their regulatory licenses or their

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<sup>4</sup> According to the Notice to Members, member firms now would be required to file any web page containing a hyperlink to a Tool maintained on a third-party Web site so the NASD staff could determine the extent to which the member is responsible for the content and filing of such third-party Tool. A prior NASD staff interpretive letter that has long permitted member firms to provide hyperlinks to "independent," third-party Internet web sites without having to take responsibility for the content or filing of such material. Interpretive Letter from Thomas Selman, NASD Regulation, to Craig S. Tyle, Investment Company Institute (Nov. 11, 1997) (the "ICI Letter"). Member firms had understood that this interpretation permitted links to a third-party's Web site that contained services, research and Tools, including investment advisers that establish their own client relationship with the Tool user.

relationships with affiliated or other third parties. For example, we have been advised that the NASD takes the position that a member firm which is also an investment adviser is subject to the rule if a Tool is deployed by it notwithstanding its SEC regulated adviser status. Therefore, an SEC-registered investment adviser (that also is an NASD member) will not be able to compete with other SEC-registered advisers (non-dual registrants) offering advisory Tools.

- Member firm customers will have fewer choices to use alternative or competitive Tools from member firms and cause some to use Tools offered by unregulated entities. Many computer vendors, investment advisers and others may not want to subject their proprietary Tools to NASD regulation, comment and design changes. Tool vendors could still provide such Tools to broker-dealers without conforming them to NASD standards if broker-dealers do not provide customers with any reports or independent, unassisted access to the Tool.
- Member firms may find it easier to use a Tool pre-approved by the NASD rather than incur the cost and expense of obtaining NASD approval of another Tool, especially since the new Tool will be required to function just like the NASD approved Tool. The time and cost involved will create disincentives for member firms to develop or seek out alternative Tools, resulting in fewer Tool choices for customers.
- The conditions, parameters, calculations and disclosures in the Interpretive Material are not “technology neutral.” Therefore, by definition the NASD rule inhibits competition because member firms may use a Tool directly only if it conforms to NASD subjective standards which do not exist today and were not made part of this filing. This regulatory approach stifles innovation to the detriment of investors.

Member firms and other commenters to the NASD voiced strong objections to the proposal because of the unnecessary costs involved and the burdens on competition. One non-member commenter wrote to thank the NASD for its “anti-brokerage firm stance” and for taking business away from broker-dealers, and noted that the NASD was making it more difficult for customers to have access to valuable Tools.

#### **NASD RULES ALREADY PERMIT “FORECASTS” OF INVESTMENT RESULTS**

NASD Rule 2210 permits member firms to present “forecasts” of future investment results provided they are not misleading or unwarranted. This is the correct approach to take. The most complex Tools indeed attempt to provide such useful forecasts. NASD Conduct Rule 2210(d)(2)(C), like NYSE Rule 472 (advertising rule) and NASD Conduct Rule 2220 (options advertising) only restricts or prohibits “exaggerated, unwarranted or misleading statements or claims,” “promises of specific results,” “opinions for which there is no reasonable basis,” and “forecasts of future events which are unwarranted, or which are not clearly labeled as forecasts.” SEC rules applicable to investment advisers discussed below also do not prohibit forecasts. Any online resource or Tool, whether or not subject to the new NASD definition, can be used to forecast investment results in a manner not unwarranted or promissory (*i.e.*, guaranteeing) and provided it is clearly labeled as a forecast in compliance with these rules. There is no

justification in the filing for expanding the concepts of projections and predictions to prohibit legitimate forecasting Tools.

If the Interpretive Material were approved, Tools could still convey permissible “forecasts,” but may not contain some types of prohibited predictions and projections. There is no meaningful difference between a permissible “forecast” and a prohibited “projection or prediction.” A forecast is typically something that is more sophisticated and is said to relate to the use of calculations to estimate or predict a future event.<sup>5</sup> Therefore, the more a Tool involves the calculation and analysis of data, the more likely it would be a permissible forecast, as compared to Tools involving little or no mathematical modeling or analysis, such as simply taking a prior return and projecting such return out geometrically into the future, much like a prohibited “prediction or projection.” However, no firm will ever know for sure whether it meets this indistinguishable standard and the result will be that anything that calculates will arguably require submission for NASD review. Clearly a result no one wants or thinks is necessary.

The NASD has never stated why Tools do not qualify as permissible forecasts under NASD Conduct Rule 2210(d)(2)(C) and other NASD rules. One would assume it would address this issue in the context of the current rule filing, but the NASD appears to have purposely avoided this issue and has not addressed how its “interpretation” of the prediction and projection prohibition relates to permissible forecasts.

### **NASD HARMONIZATION OF RULES IS A BETTER FIRST STEP**

The foundation of NASD’s proposal teeters on so many conflicts and inconsistencies within NASD rules and interpretations, and between its rules and other SRO and SEC rules, that the best way to proceed is to first fix these conflicts and inconsistencies, rather than compound them with the introduction of a new rule interpretation that adds further confusion. Because NASD rules and interpretations provide no coherent use of the terms “prediction,” “projection” and “forecast,” member firms are not on sufficient notice to know whether or not they are in compliance with NASD rules.

There are many instances in which the SEC has suggested that the SROs first address inconsistencies in their own rules before proposing new rules that add further confusion, including in the context of SRO advertising rules. For example, following SEC examination findings of conflicting and confusing SRO options advertising rules, the SEC recommended, and SROs adopted, amendments to their options advertising rules to make them consistent.<sup>6</sup> More recently, the SEC and the SROs worked together in response to public comment to use similar definitions and terms when adopting new rules for research analysts and research reports.<sup>7</sup> Therefore, we recommend that the NASD first change its advertising rule to address and clarify

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<sup>5</sup> *American Heritage Dictionary for the English Language* (4th ed. 2000).

<sup>6</sup> NASD Notice to Members 91-62 (Oct. 1991) (announcing SEC approval of the new rules); NASD Notice to Members 91-1 (Jan. 1991) (proposing to separate the options rule from the general advertising rule).

<sup>7</sup> Exchange Act Rel. No. 47110 (Dec. 31, 2002), 68 Fed. Reg. 826 (Jan. 7, 2003).

the inconsistencies below and harmonize its rules with the NYSE's rules, which already permit predictions, projections and forecasts that are not unreasonable.

### **NASD Staff Interpretations are Inconsistent and Conflicting**

The NASD's Notice to Members announcing the proposal took many members by complete surprise. Most member firms believed that several NASD rules and interpretations outlined below already authorized the use of Tools, many of which are widely used by member firms and other entities today.

- NASD rules permit the use of forecasts, and most Tools contain sophisticated calculations designed to enhance an evaluation of a portfolio, and are not based on some simple projection of a mutual fund return based on prior performance.
- Discussed more fully below, the language in Rule 2210(d)(2)(N) historically applied to generic projections of mutual fund securities based on historical returns, and aside from some vague interpretations, the NASD has not enforced this rule beyond simple advertising claims projecting a large return without foundation and tantamount to a promise or guarantee.
- Rule 2210(d)(2)(N) itself exempts some hypothetical illustrations of mathematical principles and other simulations; therefore, the rule itself does not ban all predictions and projections.
- The NASD permits the use of predictions and projections in other contexts, most specifically in the area of research reports, which can provide very detailed statistical and quantitative analyses, charts and graphs, rating and price targets, earnings targets and similar projections. Advertising rules for options investments, generally considered higher risk investments, also permit predictions and projections.
- The NASD had permitted firms to use "interactive calculators" provided they separated such Tools from specific product offerings on their web sites.<sup>8</sup>
- The NASD in the ICI Letter has permitted member firms to link to third-party web sites without having to be responsible for all products and services on such web sites, and member firms understood this to include a third-party's Tool on a web site.

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<sup>8</sup> The NASD staff has stated that "interactive calculators" in software packages (whatever they include) are not contrary to NASD rules prohibiting projections or predictions and that they may be used as part of a financial planning or "needs analysis" discussion in a software or web presentation. NASD REG. & COMPL. ALERT, Vol. 11, No. 4, "Ask the Analyst" (Dec. 1997), at 26. Because of the prohibition against "predictions and projections," the NASD stated that calculators could be used so long as they appear separately from discussions of specific products and the related text does not imply that the calculator can predict future product performance. *Id.*

- The NASD and the SEC provide Tools on their own web sites to assist investors in calculating returns on investment.<sup>9</sup> Those Tools arguably may require prior approval from the NASD under the proposed interpretation if used by a member firm or if a member provides a link to those Tools.

All these legal, historical and customary pronouncements and practices demonstrate that the NASD never applied this rule in such a broad fashion, and member firms believed that detailed Tools, much like research reports, are a different category of communications altogether.

Nevertheless, the whole foundation for the NASD's rule tilts on the newly announced "historical" staff interpretation of the "prediction and projection" language in NASD Conduct Rule 2110(d)(2)(N). The Notice to Members states that the NASD staff has "*interpreted*" Rule 2210(d)(2)(N) to "prohibit members from providing customers with access" to Investment Analysis Tools that indicate the probability of "investment strategy" and because certain client-generated input could lead to results that could constitute impermissible "predictions or projections" under the rule. Between the Notice to Members and the SEC rule filing, the NASD changed this "historical" interpretation. In its rule filing with the SEC, the Interpretive Material "*now* explains that NASD staff has interpreted Rule 2210(d)(2)(N) as prohibiting members from providing customers with access to investment analysis tools that show the probability that investing in *specific securities or mutual funds* may produce a desired result." (Emphasis added). The NASD, therefore, is proposing the Interpretive Material (a new rule) in order to exempt certain Tools (subject to onerous conditions) from this unpublished, expansive staff interpretation.<sup>10</sup>

### **NASD Rules are Internally Inconsistent**

First, NASD Conduct Rule 2210(d)(2)(N) prohibits certain "predictions and projections," but other NASD advertising rules do not. For example, NASD Conduct Rule 2220 governing options advertising permits the use of "forecasts and projections." Options sales literature is defined to include any "analysis, performance report, projection ..." and such sales literature may contain "projected performance figures" subject to certain conditions. Similarly, NASD Interpretive Material 2210-7 regarding single stock futures advertising permits the use of "projected performance figures," including annualized rates of return.

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<sup>9</sup> The NASD makes available certain calculators and tools on its Web site in its "Investor Education" area at [http://www.nasdr.com/financial\\_calculators.asp](http://www.nasdr.com/financial_calculators.asp). The SEC also has a tool available by hyperlink from its "Investor Information" site at <http://www.sec.gov/investor/tools.shtml>.

<sup>10</sup> In addition, because this staff interpretation is so novel in its application to a new communications media, it bears little relationship to the historical purpose of the rule and is so inconsistent with permissible forecasts, the staff interpretation is of questionable validity itself because it constitutes a new rule or interpretation that should be or should have been subject to the Rule 19b-4 rule filing process. The NASD's interpretation of Rule 2210(d)(2)(N) as applied to Tools amounts to a new rule and is not merely a reasonable interpretation or extension of an existing rule. For example, if the NASD staff sought to interpret this provision to prohibit predictions and projections in charts or graphs or in price or rating targets in research reports, it should do so only through a public administrative rulemaking process, and not by regulatory staff fiat.

Second, while subpart (N) prohibits certain “predictions and projections,” elsewhere in the same rule the NASD permits “forecasts” of future events. NASD Conduct Rule 2210(d)(2)(C), and NASD Conduct Rule 2220 regarding options, only prohibit “forecasts of future events which are unwarranted, or which are not clearly labeled as forecasts.” Yet, the NASD proposal does not address why a Tool as defined does not provide “forecasts of future events,” which are permissible under subpart (C) if clearly labeled as such and are not “unwarranted.”

To date, the NASD has not articulated any definitions for these terms or stated why its different and inconsistent use of them in different rules (equities/funds, options, annuities, etc.) meets any regulatory objective or need.

### **Synonymous Use of “Forecasts” and “Predictions/Projections”**

To add further confusion, several NASD and NYSE rules and interpretations use the terms “forecasts” synonymously or interchangeably with the terms “predictions and projections.” For example, NASD Conduct Rule 2220 regarding options permits the use of predictions, projections and forecasts. NASD Interpretive Materials dealing with Variable Life Insurance and Variable Annuities in IM-2210-2 uses the terms synonymously: “illustrations may not be used to *project or predict* investment results as such *forecasts* are strictly prohibited.”<sup>11</sup> In the NASD Notice to Members, the NASD’s original model disclaimer used these terms synonymously: “the *forecasts* or other information generated by [brand name of [Tool]] regarding the probabilities that various investment outcomes might occur are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results...” (Emphasis added). The NYSE’s general and options advertising rules permit predictions, projections and forecasts and use these terms largely interchangeably. As noted above, standard dictionaries also use these terms synonymously.

### **NASD Staff Interpretations Contrary to Historical Context**

NASD Conduct Rule 2210(d)(2)(N) dealing with “predictions and projections” is derived from historical SEC and NASD policy statements and guidelines governing mutual fund advertising and focused on attempts to predict or project specific future returns or results based on past performance of investment company and variable annuity products. While the NASD rule now also applies to individual securities and mutual funds, the NASD, when adopting the rule, did not suggest or contemplate that it should be applied to today’s more sophisticated and diverse online investment resources.<sup>12</sup>

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<sup>11</sup> As an example of the confusion the proposal created, almost half of the commenters supported the proposal so they could continue to use or implement various “Monte Carlo” computer simulations when selling variable insurance or annuity products. The advertising of variable insurance and annuity products are currently regulated by NASD Interpretive Material 2210-2. This rule already regulates hypothetical illustrations of rates of return, personalized illustrations and “computer generated” illustrations, including in print and on screen presentations. It is not clear whether the proposed Interpretive Material applicable to Tools would be in addition to, or in lieu of, the requirements in Interpretive Material 2210-2.

<sup>12</sup> Exchange Act Rel. No. 31845 (Feb. 10, 1993), 58 Fed. Reg. 8799 (Feb. 17, 1993) (proposing release); Exchange Act Rel. No. 32251 (Apr. 30, 1993), 58 Fed. Reg. 27603 (May 10, 1993) (adopting release). There is relatively no

Comments from a senior NASD official soon after the rule was amended also confirmed that the 1993 amendments were not intended to prohibit all communications containing investment results or even all projections or predictions.<sup>13</sup> Rather, the intent of the rule was to get at garden-variety claims by brokers stating that, for example, an investment (or a fund) will have a return of 20% next year, as compared to 18% for last year. The NASD official specifically noted that the new rules would not prohibit a research report from looking at historical earnings and “projecting” earnings for the next year, or prohibit “mathematical illustrations” such as dollar-cost averaging. In the few NASD enforcement matters under this rule, the NASD has sought to rein in unwarranted claims and promissory/guarantee statements made by representatives in typical news or advertising materials, and has not applied the rule to online investment resources widely used by member firms and others in the ten years since the rule was adopted.<sup>14</sup>

### **Conflicts with NYSE Rules**

Finally, NASD Conduct Rule 2210(d)(2)(N)’s “prediction and projection” prohibition and related NASD staff interpretations are in direct conflict with language in the NYSE’s equivalent advertising rule. NYSE Rule 472 permits “projections or forecasts of future events” provided they are “clearly labeled as forecasts.” The rule also provides that “any projection or prediction must contain the bases or assumptions upon which they are made” and must make such materials available upon request. This is a model way to treat the subject for all broker-dealers and should be the language the NASD uses in its rule. The NYSE’s options advertising rule (NYSE Rule 791) also permits use of predictions, projections and forecasts similar to the NASD’s options advertising rule.

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discussion about the reason for extending the prohibition of “predictions and projections” to all communications with the public (except apparently for options) in addition to those dealing with mutual funds. The NASD did not provide examples of prohibited practices, definitions for the new terms or commentary on how the new terms are distinguished from permitted forecasts. There was no discussion about the application of these concepts to Tools, calculators or similar medium even though many online computer models and Tools were in existence in 1993.

<sup>13</sup> Comments of R. Clark Hooper, Vice President of Advertising and Investment Company Regulation at the NASD at the time. “Three NASD Initiatives Aimed at Clarifying Communications with the Public,” NSCP Currents (Nov./Dec. 1994).

<sup>14</sup> The relatively few regulatory cases involving breaches of NASD advertising rules dealing with forecasts and predictions or projections generally are unrelated to mathematical or other computer tools. Rather, these cases involve traditional concepts of unwarranted or exaggerated claims or promises of specific results in advertising, sales pitches and similar circumstances. *E.g.*, *In re Altegris Investments, Inc.*, [http://www.nasdr.com/news/pr2003/release\\_03\\_015.html](http://www.nasdr.com/news/pr2003/release_03_015.html) (Apr. 22, 2003) (projection of 12-14% return in a research report found to be exaggerated and unwarranted); *In re Martin Lee Eng*, SEC Admin. Proc. File No. 3-10009, Exchange Act Rel. No. 44224 (Apr. 26, 2001) (“wash and sale” tax investment strategy found to contain a promise of a specific result for which there was no reasonable basis); *In re Daniel C. Montano*, SEC Admin. Proc. File No. 3-9259, Exchange Act Rel. No. 40243 (July 22, 1998) (television broadcast promised specific results and made specific dollar projections that were not merely illustrations in a short-sell strategy); *In re Robert L. Wallace*, SEC Admin. Proc. File No. 3-9549, Exchange Act Rel. No. 40654 (Nov. 10, 1998) (advertisement in newspaper touting 42% return found to contain exaggerated and unwarranted claims).

### **NASD PROPOSAL DIRECTLY REGULATES INVESTMENT ADVISERS OUTSIDE ITS JURISDICTION**

The NASD's proposed rule directly regulates investment advice by registered investment advisers, an area already regulated by the SEC and the states. Indeed, the Notice to Members states that customers using Tools enter a variety of information to "receive personalized investment advice." In addition, the NASD staff has publicly acknowledged that the Interpretive Material is a direct result of an SEC-registered investment adviser requesting interpretive relief under NASD Conduct Rule 2210(d)(2)(N) that its Tools, when used by an NASD member firm's customers, do not violate that NASD rule. The NASD would permit member firms and their customers to use an investment adviser's Tool provided the investment adviser's Tool is modified to meet NASD standards. The same investment adviser would not have to modify its Tool if it offered the Tool directly to its advisory clients or to clients of banks, 401(k) sponsors, financial planners and similar financial service providers.

The NASD proposes to actively regulate Tools, even where the SEC, as a policy matter, has exempted such Tool vendors from investment adviser regulation. First, the SEC has granted relief from investment adviser registration to various entities who had automated or computer systems, programs or calculators that provide basic market data or that offer certain computer software services that contain mathematical models and calculators.<sup>15</sup> The NASD rule, however, may apply to some of these services if provided to a member firm's customers. Second, to the extent a computer service would not meet SEC no-action letters but offers "analysis or reports" concerning securities or other investment advice, the service would still be exempt from SEC registration if such service were offered for free or by another category of persons exempt from registration.<sup>16</sup> The NASD rule, however, would apply to some of these services if provided to a member firm's customers, even without compensation to the member or the adviser.

The NASD's rule also encroaches on the Tools of SEC-registered investment advisers (and other regulated institutions, such as banks). The Advisers Act does not prohibit investment advisers, including broker-dealers registered as investment advisers, from offering investment advice using computer Tools that contain predictions, projections or forecasts. Rule 206(4)-1 under the Advisers Act prohibits advisers from publishing any advertisement (defined to include computer formulas or devices) which: (1) represents that any graph, chart, formula or other device can *in and of itself* be used to determine which securities to buy and sell; or (2) represents that such device can assist any person in making his or her own decisions as to which securities to buy or sell, or when to buy or sell them, "without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use." (Emphasis added). If an adviser advertises a "formula or other device" such as a "Tool," the adviser is not prohibited from generating forecasts or projections. The only requirement for such self-directed Tools is that the advisers disclose prominently their limitations and the difficulties with respect to their use. Even

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<sup>15</sup> Datastream International, Inc. (pub. avail. Mar. 15, 1993); EJV Partners, L.P. (pub. avail. Dec. 7, 1992); Wilson Assoc. (pub. avail. May 25, 1988); Innosearch Corp. (pub. avail. Sept. 12, 1985).

<sup>16</sup> Section 202(a)(11) of the Advisers Act provides that any person who "for compensation" advises others or issues "analyses or reports" concerning securities is an investment adviser and is subject to registration unless exempt.

though such Tools are already subject to extensive regulation and oversight by the SEC, the NASD would still superimpose its rule on any SEC regulated Tool if provided to a member firm's customers.

In addition, Rule 156 under the Securities Act of 1933 governs investment company sales literature and regulates past and future performance presentations of investment company securities. Such presentations may not include predictions based on past performance alone without sufficient context, representations implying that future gain or income can be inferred from or predicted based on past investments, or portrayals of performance in a manner that such performance "would be" repeated, *i.e.*, a guarantee. Similar to SRO rules, Rule 156 also prohibits "exaggerated," "unwarranted," or "unsubstantiated" claims or comparisons. Aside from these and other guidelines in the rule, a Tool can portray mutual fund forecasts and other analyses where there is sufficient context and does not imply that a return would be repeated or guaranteed.

Therefore, assuming the Tool offers advice and the adviser charges a fee, the Advisers Act does not prohibit all forecasts and predictions or projections; indeed, this is what advice should attempt to do. If a broker-dealer wants to offer to its customers an investment adviser's Tool, that Tool is subject to SEC Rule 206(4)-1, and to the extent it analyzes mutual funds, it would be subject to SEC Rule 156 under the Securities Act. There is no need to apply another NASD rule that would directly regulate the Tool, its format, disclosures and functionality, and would subject that adviser's Tool to an NASD filing and approval process.

What makes the proposal so disconcerting is that the NASD is interposing its judgment for that of a fiduciary. As noted, the NASD proposed the rule because a registered investment adviser wanted to make its Tool available to customers of a broker dealer. Assuming the customer would enter into an advisory relationship with the adviser/fiduciary, there is no need for the NASD to substitute its judgment (or SEC regulation) for that of the fiduciary, even if the member firm also takes on the advisory/fiduciary responsibility. The rule would regulate Tools used both in a fiduciary or in a non-fiduciary context. A member firm may want to offer a Tool as a fiduciary to an advisory client and charging a fee, in a non-fiduciary capacity where it may offer the Tool as a service incidental to a brokerage function and without receiving any special compensation, or in a self-directed format or as an educational resource (possibly from a third-party resource) without providing any advice or recommendations.

Finally, given the scope of the rule, it is not clear whether it applies to member firms that offer Tools by linking to independent, unaffiliated or even affiliated banks or investment advisers. Instead, the NASD states in a footnote that member firms need to file all such Web link pages so the NASD itself can later determine if the rule applies.

#### **SUBSTANTIVE OBJECTIONS TO THE NASD RULE CRITERIA AND NASD MERIT REVIEW**

We continue to object to several substantive conditions and procedural requirements in the current iteration of the NASD proposal.

### **Scope and Definitions Remain Unclear and are Unnecessary**

The definition of an Investment Analysis Tool remains unnecessarily broad and confusing.<sup>17</sup> The NASD attempted to clarify that certain “automated educational” Tools that present certain “portfolio analysis” financial planning may not be subject to the rule, but it appears that portfolio-based planning Tools that are more than “educational” would be subject to the rule. Based on comments to the NASD, member firms are confused as to whether only Tools that contain “a range of probabilities” are subject to the rule, and are unsure whether other Tools that contain predictions or projections and do not contain a range of probabilities are still permissible (or would now be prohibited because of the staff interpretation).<sup>18</sup> Almost half of the commenters thought the proposal was targeted to Monte Carlo simulations for insurance/annuity products (even though Rule 2210-2 already regulates computer simulations of these products). The language in the defined term is still so broad it may cover almost any online resource.

### **Conditions and Disclosures are Unnecessary, Confusing and Technology Specific**

Under the proposed rule, a member firm may provide a Tool (whether customers use the member's Tool independently or with assistance from the member), and related written reports and sales material, only if they contain all required conditions and “disclosures.” One of these conditions/disclosures contains objective, boilerplate language capable of verification (*i.e.*, no guarantee of results); however, most of the conditions and disclosures directly regulate the substantive mechanics, algorithms, features and presentation of a Tool. All Tools used by member firms must be formatted in the same way, and may need to be reprogrammed to calculate and present ranges of probabilities, upside and downside projections, estimated probabilities, key assumptions and liabilities and other disclosures, even though a simple, or a very complex, Tool, given its presentation and context, would not be misleading without such NASD requirements.

For most Tools, the NASD mandated “conditions” and “disclosures” are unnecessary either because the presentation, purpose or level of detail of the Tool is self evident, or the Tool itself contains sufficient context and disclosure without the additional NASD requirements. In

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<sup>17</sup> A Tool is defined to include “an interactive technological tool that produces simulations and statistical analyses that present a range of probabilities that various investment outcomes might occur, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns on particular investments.” Would this include a Tool that does not “present a range of probabilities” but nevertheless predicts or forecasts an investment result (possibly assigning one probability for that result), with or without any statistical analysis or simulation? What if the Tool merely projects a return on an investment using a fixed rate, but does not perform “statistical analysis” typically used to reach the likelihood or probability of a return? Does it matter if the Tool uses such simulations and statistical analysis, and/or ranges of probabilities, to perform asset allocation or portfolio rebalancing, or does it apply only if the Tool is used to project returns on individual securities or mutual funds?

<sup>18</sup> It appears that the definition includes a broader range of Tools, not just those that already present a “range of probabilities.” The SEC filing clarifies that the staff interpretation applies to those Tools that show the probability that investing in an individual security or mutual fund may produce a desired result and would be subject to the new rule. This type of Tool now must be reprogrammed to present a range of probabilities.

addition, it is likely that many Tools and their computer software (even assuming the rule applies only to those sophisticated Tools that already contain “ranges of probabilities” and performs “statistical analysis” and Monte Carlo simulations) will need to undergo costly and time-consuming re-programming and subsequent testing to conform to the NASD’s “one size fits all” requirements:

- (1) Each Tool will be required to calculate and present a “range of probabilities.”
- (2) Member firms must verify or change a Tool’s presentation to ensure the ranges of probabilities are “prominently” presented in a “fair and balanced” manner, and will have to modify their computer algorithm (or demonstrate that the algorithm) assigns a “reasonable” figure to each of the ranges of probabilities.
  - Each Tool now will be required to include specific “projections” that, at a minimum, contain an “upside,” a “downside,” and a “median” projection of estimated outcomes. (This will likely require firms to re-program the computer software to include these calculations).
  - On the downside, each Tool must include a “prominent statement of the estimated probability,” that the user may lose more money than projected (and of course further re-program the Tool computer software to calculate this figure to some degree of “estimated probability”). (It is not clear if a member firm can use an “estimated probability” that a user may gain more money than projected).
  - It is not clear whether a Tool can assign a simple probability, or must perform a more detailed Monte Carlo simulation with thousands of calculations, to assess a reasonable probability of the likelihood that each upside/downside/median range may occur.
- (3) Each Tool’s mathematical process must be subject to some form of “audit and review” capability. Most Tools are computer programs that contain mathematical calculations, with the more detailed Monte Carlo simulations performing tens of thousands of calculations based on variables that can change. No guidance is provided as to how a member firm must audit the Tool, what features are subject to an audit requirement or whether it applies on a per client basis. One possible way to comply would be to obtain a copy of the computer program and have a mathematician verify the soundness of the math calculations. However, many Tools are purchased from third-party vendors who view their computer programs and their calculations as proprietary and may not agree to waive confidentiality provisions in licensing agreements.
- (4) Each Tool may need to be modified to describe the criteria and methodology used, including the Tool’s “limitations and key assumptions.” The NASD had proposed that member firms provide detail disclosure of mutual fund attributes, tax implications, costs and fees, interest rate and inflationary analysis, historical performance and performance over time, but deleted these specific requirements from the current proposal. We assume, therefore, that only general disclosure now is expected and hope examiners

10 years from now will remember this legal compromise. The criteria, methodology, limitations and key assumptions typically are self evident to a user when inputting data, and the NASD model disclaimer sufficiently addresses this issue. Otherwise, the criteria and methodologies of some Tools are protected by intellectual property rights. Also, Tools are not intended to be all things to all investors, and limitations may vary depending on the type of user or the purpose for which it is being used.

(5) The Tool must explain that results may vary with each use and over time. Again, such information should be self evident, and more importantly the NASD model disclaimer addresses this issue.

(6) Each member firm must disclose clear conflicts or affiliate recommended securities. These requirements already exists in current NASD rules. A Tool also must somehow disclose “the universe” of securities used to possibly fill hypothetical portfolios, and if firms do not use the entire universe, they must disclose whether excluded securities could perform better. This latter requirement could include countless investments that are excluded and is simply impossible to evaluate.

(7) Finally, the NASD requires a model disclaimer basically reminding the investor that, notwithstanding all the above “disclosures,” they should not expect or believe that a result produced by the Tool will work in the real world and that projected results are not guaranteed.<sup>19</sup>

Rather than mandate each of these disclosures, the better approach would be to require that member firms offer such information to users upon request.

On a broader regulatory policy level, the NASD rule, and its specific conditions and disclosures, are contrary to SEC and NASD regulation over the past 20 years in this area. For example, the SEC when adopting Rule 156, and the NASD when adopting the predecessor to Rule 2210(d)(2)(N), specifically stated that they did not want to regulate specific presentation formats precisely because of evolving technology and the usefulness of alternative presentations.<sup>20</sup> They

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<sup>19</sup> The model disclaimer provides: “IMPORTANT: The projections or other information generated by [name of [Tool]] regarding the probabilities that various investment outcomes might occur are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. [Name of [Tool]] only presents a range of possible outcomes.”

<sup>20</sup> Securities Act Rel. No. 6034 (Mar. 8, 1979), 44 Fed. Reg. 16935 (Mar. 20, 1979) (withdrawing the Statement of Policy and proposing Rule 156); Securities Act Rel. No. 6047 (Mar. 27, 1979), 44 Fed. Reg. 21007 (Apr. 9, 1979) (withdrawal of Statement of Policy); Securities Act Rel. No. 6140 (Oct. 26, 1979), 44 Fed. Reg. 64070 (Nov. 6, 1979) (Rule 156 adopting release). The SEC stated that it deliberately used general language in the new rule so that it would not be construed as prohibiting or permitting any particular representation. Similar to the SEC’s approach when adopting Rule 156, the NASD stated that its Guidelines Regarding Communications With the Public About Investment Companies and Variable Contracts (the “Guidelines”), the precursor to current Rule 2210, “are cast in terms of general principles ... and they do not set forth precise, rigid formulas or requirements” and “are intended to allow maximum creative flexibility and avoid the rigidity of the previous Statement of Policy....” See NASD

therefore chose to adopt broad guidelines so firms would have the flexibility and incentives to experiment and compete. The NASD rule proposal, however, is contrary to that longstanding regulatory approach in this area and attempts to specify the minimum calculations, presentation, content and context of each Tool used by a member firm and to place the subjective determination of whether that standard is met into the hands of the NASD Advertising Department.

In this regard, the NASD rule, and the review and comment process, are contrary to the core principle of “technology neutral” regulation that online service providers (and Congress, *e.g.*, E-SIGN) adhere to. Member firms will likely need to re-program their or their vendor’s computer software so they all contain these same conditions and “disclosure” requirements. Consistent with prior regulatory approaches, member firms should have the flexibility to determine the content, context and presentation of their Tools, and the level of detail to be used in each Tool’s internal algorithms.

#### **PROBLEMATIC FILING AND APPROVAL PROCEDURES**

The Interpretive Material proposes that member firms provide the NASD Advertising Regulation Department with “access” to any interactive Tool 30 days prior to use, and “file” with the NASD any related sales materials and templates for written reports. The Interpretive Material also states that member firms will be obligated to submit supplemental information to the NASD, if requested, and may not use a Tool or related reports or templates until all changes specified by the NASD have been made and are subsequently approved by the NASD. Member firms would be required to somehow file a Web page linking to any Tool that is contained in or through any third-party Web site, whether independent or affiliated. Even though a “Tool” and related “reports and “sales material” are not defined as “advertisement” or “sales literature” under NASD Rule 2210, member firms not otherwise subject to NASD filing, review and approval of advertising now would be subject to these new requirements.

The rule clearly prohibits member firms from using a Tool unless the NASD approves the Tool and all subsequent changes. The NASD rule also states that “[n]o member may imply that the NASD ... approves the use of any investment analysis tool...” As drafted, this literally prohibits member firms from telling the truth, *i.e.*, that the Tool is approved by the NASD. Many customers will know that such Tools are subject to an NASD approval process and when asked by customers, member firms can either be silent or violate the NASD rule.

The NASD’s rule filing also states that the NASD approval requirement is not a “merit-based” review, and that the NASD staff will review the Tool merely to confirm that the disclosures in the Interpretive Material and other NASD rules are made. If this is true, then there is no need for prior filing and review, but the NASD could simply check a member firm’s objective disclosures in due course or based on a submission made after first use. Aside from the objective

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Notice to Members 81-9 (Mar. 10, 1981) (proposing the Guidelines for member comment); NASD Notice to Members 82-5 (Feb. 8, 1982) (adopting the Guidelines).

“disclaimer” requirement, the other required “disclosures” do not lend themselves to simple checking of required or objective language. Rather, the only way to verify whether the Tool makes the disclosures or makes them correctly is to test the Tool using fictitious data to determine whether the “disclosures” are reasonable. This will necessarily require a series of subjective evaluations.<sup>21</sup> The NASD staff is not equipped to perform this review and has stated that it does not intend to do such a review.

This filing, comment and approval process raises additional problems for member firms seeking to comply with changes required by the NASD. Most member firms license Tools and related software from third-party vendors. These vendors have their own patent or other intellectual property rights that pertain to the system, and may be reluctant, without significant cost or expense, to modify and re-test the computer program in order to accommodate NASD staff demands. Vendor relationships also are typically subject to confidentiality agreements that restrict access to certain proprietary calculations. These vendors have alternative markets, such as banks, investment advisers, financial planners, unregulated financial Internet Web sites, etc. where they can license their software Tools. Some broker-dealers also can be a potential market for unmodified Tools of independent vendors if they use the Tool internally or permit brokers to use the Tool without delivering any written materials to investors.

From a cost perspective, it is common for vendors to require significant up-front development fees for initial customization, which can cost hundreds of thousands of dollars. Many of these development and licensing agreements also contain monthly license fees. Firms will have to incur these cost without knowing whether the Tool will obtain NASD approval, and without knowing whether the vendor will change fundamental, proprietary features of the Tool if demanded by the NASD. Further, some member firms may be using Tools subject to long term contracts and monthly licensing fees, and the agreements governing those relationships may permit termination only upon a material breach, but not necessarily if the NASD requires a member firm to cease using the Tool.

From a timing perspective, the filing and approval procedure would place member firms without such Tools at a competitive disadvantage. The development and initial deployment may take 3 to 8 months, and possibly longer when trying to accommodate new NASD requirements, and firms must then wait a minimum of 30 days or longer for NASD approval, subject to comment,

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<sup>21</sup> If done right, NASD examiners will need to test each Tool by inputting data into the Tool several times to confirm that the tool in fact produces a “range of probabilities” and make a subjective determination that the ranges are appropriate and not too narrow or wide and are somewhat capable of being repeated. If the examiner inputs the same data more than once and obtains different ranges or probabilities, which is likely given many Tools have built-in external variables, the examiner will need to probe further into the mechanics of the Tool to determine why before approving the Tool. To assess whether the range of probabilities appear fair and balanced, the examiner would need to compare the results against different “test case” customers. The examiner may need to obtain a copy of the confidential intellectual property (the computer source code) of the Tool provider to ensure the mathematical formula contained in the Tool can be audited. The examiner also will need to somehow use the Tool on a member firm’s systems to confirm whether it is skewed to select products sponsored by or affiliated with the member firm or the tool provider. Finally, the examiner will need to test other non-proprietary/affiliate products to confirm they do not provide better results on a consistent basis as compared to proprietary products.

while a competitor already has an operational system. A comment requiring any computer program change, re-testing and resubmission to the NASD could take many months and tens of thousands of dollars to finalize.

This review process, therefore, creates separate costs and disincentives, resulting in fewer Tools likely being used and reducing competition. All of this argues for abandoning the proposed pre-use review process and adopting instead a post first use filing or permitting firms to file and obtain NASD feedback on a voluntary basis.

### **SUMMARY**

As noted, the NASD has proposed a supportable goal – to permit a way for member firms to offer, and for consumers to have access to, modern, interactive investment Tools. We believe that the proposed Interpretive Material, however, is not necessary and is confusing and unworkable. We believe the stated NASD interpretation of the terms “predictions or projections” is misplaced and should be withdrawn. NASD and NYSE rules permit “forecasts of future results,” and NASD options rules and NYSE advertising rules permit “projections,” “predictions” and “forecasts.” We recommend that the NASD withdraw the proposed Interpretive Material, and amend its rules to be internally consistent and harmonized with NYSE rules. The NASD should be able to conclude that Investment Analysis Tools containing investment results involve permissible forecasts. Existing NASD and NYSE rules provide adequate protection for consumers against Tools that “promise specific results,” contain “exaggerated or unwarranted claims” or contain “misrepresentations.”<sup>22</sup> The NASD’s prior Suitability Interpretation in NASD Notice to Members 01-23 (April 2001) also addresses possible “recommendations.” Finally, we do not believe the NASD should regulate any Tool that offers investment advisory services, which is subject to SEC jurisdiction. Also, given the burdens on competition and costs of compliance, the proposal is unnecessary in the absence of any articulated investor confusion or industry problem.

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<sup>22</sup> If the NASD believes that firms are not providing sufficient warnings or disclosures, we would support a single, clear disclosures to address this generalized concern. However, in the absence of any industry problem or examples where consumers have been confused by such Tools, we believe one or two general “reminders” at either the beginning or the end of the process would be more effective than the range of disclosures and conditions the NASD Interpretive Material proposes.

Mr. Jonathan G. Katz

April 24, 2003

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Once again, thank you for your consideration of and the opportunity to comment on these important industry measures. Please feel free to contact me or Michael J. Metzger, Esq. at (202) 625-3696 if you have any questions.

Respectfully,

Michael J. Hogan

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  
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