Investment Analysis Tools, Securities Intermediaries, and Consumer Credit Reports

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NASD Permits Limited Use of Investment Analysis Tools With Customers

On September 28, 2004, the SEC approved an NASD Interpretive Material ("IM") to Rule 2210(d)(1)(D)—designated IM-2210-6—concerning the use of "investment analysis tools" by NASD members in counseling their customers.[1] IM-2210-6 defines an investment analysis tool as "an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken."

Rule 2210(d)(1)(D) prohibits any communications with the public that "predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." This rule had effectively prevented NASD members from using investment analysis tools for making predictions or projections regarding a customer's investments or investment strategy. That restriction was incompatible with the increased public appetite, particularly in recent years, for access to more information and tools for making investment decisions. With IM-2210-6, members can take advantage of a limited exception to Rule 2210(d)(1)(D) for the use of investment analysis tools when certain disclosure and other requirements are met.

Under the circumstances and conditions prescribed in IM-2210-6, beginning February 14, 2005, members may offer customers the use of investment analysis tools, as well as written reports generated by, and sales material regarding, such tools. IM-2210-6 covers the use of such tools by the customer with the member's assistance or by the customer independent of the member.

Disclosure requirements

IM-2210-6 requires members to make certain disclosures, which must be "clear and prominent" and must be in "written (electronic or hard copy) narrative form." Specifically, IM-2210-6 permits use of an investment analysis tool only if the member:

- Describes the criteria and methodology used, including the investment analysis tool's limitations and key assumptions.
- Explains that results may vary with each use and over time.
- Describes, if applicable, the universe of investments considered in the analysis; explains how the tool determines which securities to select; discloses if the tool favors certain securities and, if so, explains the reason for the selectivity; and states that other investments not considered may have characteristics similar or superior to those being analyzed.
- Displays the following disclosure: "IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results."[2]

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Access and filing requirements

Another important feature of IM-2210-6 is the requirement that members report their use of investment analysis tools and related written reports and sales material to the NASD. IM-2210-6 requires that members, within ten days of first use of a tool, provide the NASD with access to the tool and file "any template for written reports produced by, and sales material concerning, the tool." Members that already are using an investment analysis tool (even those that already have made the requisite filing) must file (or re-file) with the NASD the tool, any template for written reports produced by the tool, and sales material used in connection with the tool by February 24, 2005.

If a member makes any material changes to the presentation of information or disclosures, the member must so notify the NASD and re-file any templates and sales material. The NASD stated that its review of these materials "generally will focus on whether the member has made the proper disclosures."[3]

Exceptions to IM-2210-6's coverage

An "investment analysis tool" is distinct from a "hypothetical illustration of mathematical principles . . . [that] does not predict or project the performance of an investment or investment strategy"; such hypothetical illustrations are permitted under Rule 2210(d)(1)(D). Hypothetical illustrations include, but are not limited to, Web-based calculators that compute future returns based on certain assumptions.

Furthermore, investment analysis tools offered exclusively to "institutional investors"[4] are not subject to the access and filing requirements so long as the communications relating to or produced by the tool meet the criteria for "institutional sales material."[5] The key component of this provision is that the investment analysis tool may be offered *only* to institutional investors.

Finally, sales material that contains "only an incidental reference to an investment analysis tool" is exempt from the disclosure, access, and filing requirements of IM-2210-6. If the material provides any description of the tool or its features, however, the sales material would then be subject to all of the requirements of IM-2210-6.

If the member's Web site hyperlinks to an investment analysis tool on an affiliated or unaffiliated Web site, and the member is "responsible for the information on the hyperlinked Web site," the member must comply with IM-2210-6 or discontinue the hyperlink.[6]

Compliance pointers

Members must be sensitive to the possibilities for conflicts of interest in connection with the use of investment analysis tools. Members should ensure that the investment analysis tools they use with their customers are not biased toward any particular securities or investment strategies. If a member employs a tool that is predisposed, for whatever reason, to particular securities or strategies, the member should, at a minimum, provide to customers full disclosure of this fact and its impact on the results produced by the tool.

Furthermore, members should be aware that compliance with IM-2210-6 is not a safe harbor and that it does not ensure that the member also is complying with all applicable securities laws, regulations, and rules, including the NASD's suitability rule, Rule 2310. Rule 2310 requires that members, when recommending to a customer a particular transaction in a security, ensure that the recommendation is suitable for the specific customer "upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Under this rule, members have a duty to obtain information regarding the customer's financial status, tax status, and investment objectives, as well as any other information "used or considered to be reasonable by such member or registered representative in making recommendations to the customer." Because of members' suitability obligations, access to an investment analysis tool should be limited to those customers for whom the tool is suitable.

SEC Prohibits Issuer Restrictions on Securities Intermediaries

On December 7, 2004, the SEC adopted new Rule 17Ad-20 to prohibit registered transfer agents from effecting any transfer of any publicly traded

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security if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary "in its capacity as such."[7] The rule was designed to promote the efficiency of the U.S. clearance and settlement system and will become effective March 7, 2005.

Rule 17Ad-20 targets a small but growing trend among issuers to prevent the common practice of customers holding their securities through a securities intermediary. This practice involves registering the customer's security in the name of the intermediary or in its nominee name (holding the security in "street name"), for the benefit of the customer. Intermediaries often hold securities for their customers to facilitate the clearance and settlement of securities transactions by centralizing and automating the settlement process. The practice reduces paperwork and uses book-entry adjustments instead of the physical delivery of security certificates to effect transfers in ownership.

Arguments for and against Rule 17Ad-20

The SEC adopted Rule 17Ad-20 because increasingly more issuers had placed restrictions on the ownership of the issuer's securities by securities intermediaries—especially clearing agencies. In most cases, the restrictions prevented the beneficial owner of the security—the customer—from holding a security in the manner the customer deemed appropriate (i.e., through an intermediary).

Many of the issuers' restrictions required the physical delivery and transfer of certificated securities—a manual process that is time-consuming and involves increased risk for the customer and costs and time for settling trades in securities. The Commission found that these restrictions ran counter to its mandate in Section 17A of the Exchange Act to develop a "modern, nationwide system for the safe and efficient processing of securities transactions that serves the interests of the financial community and the investing public."[8]

On the other hand, many issuers argued that the restrictions on ownership by securities intermediaries protected the issuers' shareholders and their stock price from naked short selling. Specifically, by restricting registered ownership by a securities intermediary, the issuers claimed that it became impossible for short sellers to maintain a naked short position because broker-dealers would be forced to deliver certificates to the purchaser after each transaction.

The SEC responded to this concern by noting that transfer restrictions are not the appropriate way to combat naked short selling. The Commission also stated that it had recently adopted Regulation SHO, which addresses many of the problems with naked short selling.

Coverage of Rule 17Ad-20

Under Rule 17Ad-20, "securities intermediary" is defined as a "clearing agency registered under Section 17A of the Exchange Act or a person, including a bank, broker, or dealer, that in the ordinary course of business maintains securities accounts for others." This is a broad definition that includes securities clearing houses like the Depository Trust Company.

Rule 17Ad-20 is tailored to target only publicly traded securities. The rule covers all equity securities registered under Section 12 or any equity security that subjects an issuer to reporting under Section 15(d) of the Exchange Act. The rule specifically excludes from coverage any equity security issued by a partnership, as defined in Item 901 of Regulation S-K. Furthermore, restrictions on transfers imposed by private placements and other such private contracts are not implicated by the rule because these restrictions are not directed against the securities intermediaries "in their capacity as such."

SEC Requires Financial Institutions to Protect Customer Credit Reports

On December 2, 2004, the SEC adopted amendments to Rule 30 under Regulation S-P to give effect to Section 216 of the Fair and Accurate Credit Transactions Act of 2003.[9] The amendments became effective January 11, 2005, and require any broker or dealer (other than notice-registered broker-dealers), investment company,[10] registered investment adviser, and transfer agent registered with the SEC "who maintains or possesses consumer report information or any compilation of consumer report information

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derived from a consumer report for a business purpose" to take "reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal."

Amended Rule 30 covers "consumer reports" and "consumer report information," which are "any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report." However, the Commission created an exception for information derived from such reports that does not identify individuals, "such as aggregate information or blind data."[11]

The Commission also elaborated on what constitutes "disposal." Disposal means either "the discarding or abandonment of consumer report information," or "the sale, donation, or transfer of any medium, including computer equipment, on which consumer report information is stored."[12]

When disposing of consumer report information, financial institutions must make reasonable efforts to protect against unauthorized disclosure. To determine what is reasonable, the Commission stated that it expects covered entities "to consider the sensitivity of the consumer report information, the nature and size of the entity's operations, the costs and benefits of different disposal methods, and relevant technological changes."[13] Reasonable measures also include employee training and the development of disposal policies.

1 *See* SEC Release No. 34-50463 (Sept. 28, 2004), *available at* <www.sec.gov/rules/sro/nasd/34-50463.pdf>. The NASD published a Notice to Members regarding IM-2210-6 in November. NASD Notice to Members 04-86 (Nov. 16, 2004), *available at* <www.nasd.com/stellent/groups/rules_regs/documents/notice_to_members/nasdw_012413.pdf>.

2 NASD Notice to Members 04-86, *supra* note 1, at 1028.

3 *Id.* at n.7.

4 Rule 2211(a)(3) defines an institutional investor as any "person described in Rule 3110(c)(4), regardless of whether that person has an account with an NASD member; . . . governmental entity or subdivision thereof; . . . employee benefit plan that meets the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and has at least 100 participants, but does not include any participant of such a plan; . . . qualified plan, as defined in Section 3(a)(12)(C) of the Act, that has at least 100 participants, but does not include any participant of such a plan; . . . NASD member or registered associated person of such a member; and . . . person acting solely on behalf of any such institutional investor."

5 Rule 2211(a)(2) defines institutional sales material as "any communication that is distributed or made available only to institutional investors."

6 NASD Notice to Members 04-86, *supra* note 1, at n.5. *See* NASD Interpretive Letter, Response to Recommendations of the Investment Company Institute Concerning Hyperlinks (Nov. 11, 1997), *available at* <www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002542&ssSourceNodeId=308>.

7 SEC Release No. 34-50758A (Dec. 7, 2004), *available at* <www.sec.gov/rules/final/34-50758a.htm>.

8 *Id.* at Section V.A.

9 SEC Release No. 34-50781 (Dec. 2, 2004), *available at* <www.sec.gov/rules/final/34-50781.htm>.

10 For purposes of this rule, investment companies include entities defined as investment companies under the Investment Company Act of 1940, as well as investment companies not registered with the Commission, including business development companies. The Commission has stated, however, that unregistered hedge funds are not covered by Regulation S-P, and therefore would be exempt from new Rule 30. Staff Responses to Questions about Regulation S-P, *available at* <www.sec.gov/divisions/investment/guidance/regs2qa.htm>. Hedge funds would, however, have to abide by similar requirements recently adopted by the Federal Trade Commission. Disposal of Consumer Report Information and Records, 69 Fed. Reg. 68,689 (Nov. 24, 2004) (to be codified at 16 C.F.R. pt. 682), *available at* <www.ftc.gov/os/2004/11/041118disposalfrn.pdf>.

11 SEC Release No. 34-50781, *supra* note 9, at Section II.A.1.

12 *Id.*

13 *Id.* at Section II.A.2.

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