

## Comment Letter on Proposed Changes to NASD Rules Regarding Customer Correspondence Standards, May 1998

May 29, 1998

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

**Re: Proposed NASD Rule Change Relating to Standards for Individual Correspondence  
(File No. SR-NASD-98-29)**

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on NASD Regulation, Inc.'s ("NASDR") proposal to amend NASD Rule 2210 to subject individual correspondence to the general and certain specific standards of Rule 2210.<sup>2</sup> As discussed below, although the current proposal is an improvement over NASDR's prior proposal to amend Rule 2210,<sup>3</sup> the Institute continues to believe that the proposed amendments are unnecessary. If the Commission nevertheless intends to approve the proposed rule change, certain revisions should be made before adopting this proposal.

### The Proposal is Unnecessary to Address the Perceived Wrongful Conduct

The Institute commends NASDR for responding to comments and revising the prior proposal to provide a more rational application of Rule 2210's provisions to individual correspondence. In particular, we appreciate that NASDR has determined only to subject correspondence to those standards of Rule 2210 that prohibit misleading statements and not to subject correspondence to its specific disclosure requirements. As we discussed in our letter to NASDR regarding the prior version of this proposal,<sup>4</sup> however, we continue to believe that it is unnecessary to subject individual correspondence to any of Rule 2210's standards in order to address the perceived wrongful conduct of a few NASD members.

NASDR has identified three 1995 and 1996 NASD disciplinary matters as the basis for this proposed rule change.<sup>5</sup> NASDR states that it was unable to discipline certain registered representatives of NASD members for violations relating to the use of correspondence because the NASD National Business Conduct Committee (which heard these proceedings) declined to apply Rule 2210's standards to individual correspondence. NASDR has argued that this problem can best be resolved going forward by amending Rule 2210 to specifically apply its provisions to correspondence. We disagree; the rule change is unnecessary for the reasons discussed below.

First, NASDR recently amended Rules 3010 and 3110 to require members to establish detailed written procedures for the supervision and review of written and electronic registered representative correspondence relating to members' investment banking or securities business.<sup>6</sup> The chance of misleading correspondence being sent to customers is even more remote given the heightened scrutiny that members are now required to give to correspondence. Accordingly, NASDR should allow members time to implement the required new policies and procedures regarding review and supervision of correspondence to see if they resolve any perceived industry-wide problems before imposing additional requirements on members. Additionally, the amendments to Rules 3010 and 3110 give NASDR new grounds for sanctioning NASD members that fail to adequately supervise their registered representatives' correspondence.

Second, three isolated incidents of possible misuse of correspondence, all of which occurred more than two years ago, are not sufficient grounds for revising the substantive requirements applicable to all NASD members' correspondence. Putting aside any regulatory requirements, it is in member firms' own interest to assure that their correspondence is not misleading, given the desire to

maintain strong customer relationships and to avoid potential liability. Thus, there is an inherent control mechanism already in place, as evidenced perhaps by the low number of cases in which this problem has arisen. Moreover, as we stated in our earlier letter regarding this proposal, in almost all such cases, NASDR should be able to apply existing NASD rules that require members to act fairly with, and not defraud or manipulate, their customers to prevent such conduct or to discipline those that engage in such conduct.<sup>7</sup>

Accordingly, the Commission should not adopt this proposed rule change. If the Commission is nonetheless inclined to adopt this proposal, several changes should be made to the rule, as discussed below.

## Application of Commission Advertising Rules

Although the proposal appears not to be intended to subject correspondence to the Commission's advertising rules, this is not entirely clear. As the proposing release notes, several commenters on the earlier proposal expressed concern that it would subject correspondence to the provisions of Rules 134, 135a and 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940. Although the proposal appears only to subject correspondence to the general and certain specific standards of Rule 2210(d), Rule 2210(e) provides that "members' public communications shall conform to all applicable rules of the Commission, as in effect at the time the material is used." Because the term "communications with the public" would include correspondence as well as advertisements and sales literature, the proposal currently is ambiguous as to this issue.

The investment company industry has always viewed Rules 134, 135, 482 and 34b-1 as not applying to correspondence and applying only to advertising and sales literature.<sup>8</sup> Accordingly, if the proposal were deemed to subject correspondence to the Commission's advertising rules, it would have a significant impact on NASD members' operations. This would greatly complicate the process of reviewing correspondence and place increased and unwarranted demands on member training programs, as presumably all personnel who send correspondence to customers would be charged with the knowledge of the intricacies of the Commission advertising rules. Additionally, applying the Commission's advertising rules to correspondence would substantially increase members' costs of both reviewing correspondence and preparing and distributing fund prospectuses, since in many cases correspondence would have to qualify as either a Rule 482 "omitting prospectus" or supplemental sales literature.

As indicated above, given that the proposal is intended only to prohibit correspondence from being misleading and not to subject correspondence to specific disclosure requirements, we do not believe that the proposal should be interpreted to subject correspondence to the Commission's advertising rules. In order to clarify this issue, therefore, we recommend that Rule 2210(e) be amended to provide that, "In addition to the provisions of paragraph (d) of this Rule, members' advertisements and sales literature shall conform to all applicable rules of the Commission . . ." (changes in italics). By making this change, paragraph (e) will not be misinterpreted as subjecting correspondence to the Commission's advertising rules.

## Definition of "Correspondence"

The proposal would define correspondence to include any written or electronic communication prepared for delivery to a single current or prospective customer. As noted above, NASDR's principal concern in proposing this rule change is apparently to address the types of situations that arose in the disciplinary cases cited in the release. In those cases, registered representatives allegedly used misleading correspondence in connection with the offer or sale of a security. Accordingly, the term "correspondence" should not include communications that do not involve the offer or sale of a security, such as correspondence that communicates routine account information.

For this reason, the definition of "correspondence" should be revised as follows (changes in italics):

Correspondence—For purposes of this Rule and any interpretation thereof, "correspondence" means any written or electronic communication prepared for delivery to a single current or prospective customer in connection with the offer or sale of any security, and not for dissemination to multiple customers or the general public.

## Other Comments

### Rule 2210(d)(1)(A)

Rule 2210(d)(1)(A) requires all member communications with the public to be based on principles of fair dealing and good faith and to provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. We do not object to requiring correspondence to be based on principles of fair dealing and good faith. We are concerned, however, that requiring a "sound basis" for evaluating statements in correspondence regarding a particular security, industry discussed or service offered may result in extensive disclosures being required in correspondence that discusses a member's products or services. Such disclosures may be unnecessary or distracting, particularly where the correspondence is

directed to a sophisticated customer.

Accordingly, the requirement to provide a "sound basis" for such statements should be limited to advertisements and sales literature. The first sentence of Rule 2210(d)(1)(A) should be revised as follows (changes in italics):

All member communications with the public shall be based on principles of fair dealing and good faith, and advertisements and sales literature should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered.

### **Rule 2210(d)(1)(D)(ii)**

The third sentence of Rule 2210(d)(1)(D)(ii) suggests that it is not always possible to restrict the readership of a particular communication, and that accordingly even communications that are directed to a limited audience or a single customer should be drafted with a broader audience in mind. We believe that it is inappropriate to suggest that correspondence directed to a single customer may have a broader readership and should be drafted accordingly. In many cases, customer correspondence contains confidential customer information; if members must assume that such correspondence will be read by persons other than the addressee, members would never be able to send such correspondence for fear of invasion of the customer's privacy. Accordingly, the phrase "or a single customer" in the third sentence of Rule 2210(d)(1)(D)(ii) should be deleted.

### **Rule 2210(d)(2)(L)**

Rule 2210(d)(2)(L) provides that, if taxes are payable upon redemption of an investment, this fact must be disclosed. Rule 2210(d)(2)(L) also provides that references to tax-free or tax-exempt current income must indicate which income taxes apply and which do not apply unless income is free from all applicable taxes. Consistent with the theme of not subjecting correspondence to the specific disclosure requirements of Rule 2210, these provisions should apply only to advertisements and sales literature, and not to correspondence. Accordingly, the second and third sentences of Rule 2210(d)(2)(L) should be revised as follows (changes in italics):

If taxes are payable upon redemption, that fact must be disclosed in advertisements and sales literature. References in advertisements and sales literature to tax free/tax exempt current income must indicate which income taxes apply and which do not unless income is free from all applicable taxes.

\* \* \*

We appreciate the opportunity to comment on this proposed rule change. If you have any questions, please contact the undersigned at (202) 326-5819.

Sincerely,

Joseph P. Savage  
Assistant Counsel

cc: Thomas M. Selman  
Vice President  
Investment Companies and Corporate Finance  
NASD Regulation, Inc.

Thomas Pappas  
Assistant Director  
Advertising Regulation  
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### **ENDNOTES**

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,024 open-end investment companies ("mutual funds"), 438 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about \$4.932 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

<sup>2</sup> Securities and Exchange Commission Release No. 34-39942 (May 1, 1998), 63 Fed. Reg. 25532 (May 8, 1998). The proposal would subject individual correspondence to the general standards under Rule 2210(d)(1) and the following specific standards of Rule 2210(d)(2): (i) subparagraph (d)(2)(C), which prohibits exaggerated, unwarranted or certain other specific claims or opinions; (ii) subparagraph (d)(2)(E), which prohibits certain offers of free services; (iii) subparagraph (d)(2)(F), which prohibits certain claims for research services; (iv) subparagraph (d)(2)(G), which prohibits certain hedge clauses; (v) subparagraph (d)(2)(J), which prohibits the

implication of endorsement or approval by regulatory organizations; (vi) subparagraph (d)(2)(L), which prohibits certain statements regarding tax free or tax exempt returns; and (vii) subparagraph (d)(2)(N), which prohibits predictions and projections of investment results.

<sup>3</sup> See NASD Notice to Members 97-37 (June 1997).

<sup>4</sup> See Letter from Joseph P. Savage, Assistant Counsel, Investment Company Institute, to Joan Conley, Corporate Secretary, NASD Regulation, Inc. (July 14, 1997).

<sup>5</sup> See 63 Fed. Reg. at 25536 n.4 and accompanying text.

<sup>6</sup> See Securities and Exchange Commission Release No. 34-39866 (April 14, 1998), 63 Fed. Reg. 19778 (April 21, 1998). A member must, among other things, identify how supervisory reviews will be conducted and documented, identify what types of correspondence will be pre- and post-reviewed, identify what positions within the firm will be responsible for review of correspondence, specify the minimum frequency of reviews, monitor the implementation and compliance with the policies, and periodically re-evaluate the effectiveness of the firm's policies and procedures.

<sup>7</sup> For example, Rule 2110 requires members to observe high standards of commercial honor and equitable principles of trade in the conduct of their business. Rule 2120 prohibits members from effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive or fraudulent device or contrivance. Rule 2310 requires that, in recommending to a customer the purchase, sale or exchange of any security, the member must have reasonable grounds for believing that the recommendation is suitable for the customer based on facts disclosed by the customer, and requires members to make reasonable efforts to obtain certain information from non-institutional customers prior to executing a recommended transaction. Members also have a fundamental responsibility to deal fairly with customers as set forth in IM-2310-2.

<sup>8</sup> This view is supported by the fact that material permitted under Rule 134 is referred to as "tombstone advertisements," Rule 135a is entitled "Generic Advertising," Rule 482 by its terms only applies to "advertisements," and Rule 34b-1 applies only to "[a]ny advertisement, pamphlet, circular, form letter or other sales literature." Additionally, Section 24(b) of the Investment Company Act also only requires the filing of "any advertisement, pamphlet, circular, form letter, or other sales literature." 15 U.S.C. § 80a-24(b). Rule 24b-1 under the Investment Company Act defines "form letter" to mean an identical or substantially similar letter sent to 25 or more persons within a 90-day period. 17 C.F.R. § 270.24b-1(a).