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Comment Letter on NASDR Securities Recommendations Proposal, August 2001

August 15, 2001

Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

Re: NASD Notice to Members 01-45 (Required Disclosures for Securities Recommendations)

Dear Ms. Sweeney:

The Investment Company Institute[1] appreciates the opportunity to comment on NASD Regulation's request for comment on proposed amendments to NASD Rule 2210, Communications with the Public.[2] Most of our comments are limited to the effect of the proposal on investment advisory personnel, in particular portfolio managers of mutual funds and other discretionary accounts.[3] In addition, we have several comments regarding the use and scope of the term "recommendation." Finally, we request clarification on certain other matters relating to the scope of the proposal.

I. Application of Proposal to Investment Advisory Personnel

NASDR's proposal would impose new disclosure requirements upon NASD members and their associated persons in an effort to address the potential conflicts of interest presented by analyst recommendations. These disclosure requirements also would apply to "portfolio managers of investment companies and other discretionary accounts ... where these managers are also associated persons of an NASD member."[4] The Institute strongly opposes the application of the proposed rule change to such portfolio managers.

First, as a general matter, we believe the proper context for any new requirements on portfolio managers is rulemaking by the Securities and Exchange Commission under the Investment Advisers Act of 1940 and/or the Investment Company Act of 1940. If portfolio managers, when discussing securities during a public appearance, are not providing disclosures necessary to alert investors of potential conflicts of interest, this raises issues under those statutes. The fact that such individuals may also happen to be associated with an NASD member is simply irrelevant. Indeed, it would be odd for there to be different standards for portfolio managers depending on whether or not they are associated with a broker-dealer.[5]

In addition, the proposal does not consider the differences in the potential conflicts of interest presented by "sellside" analyst recommendations and statements made by portfolio managers.[6] As such, the proposal fails to recognize that, at least in the great majority of cases, any potential conflicts of interest for portfolio managers would be greatly attenuated. For example, mutual fund portfolios are generally comprised of a relatively large number of securities. It is therefore difficult to see how a portfolio manager discussing a security held in a fund's portfolio during a public appearance would have a significant impact on the performance of the fund. In addition, in such a case, it is less likely that a conflict of interest would arise as the portfolio manager, by previously purchasing the security and presently holding the security in his fund, presumably must truly believe that the recommended security is a "good buy."

NASDR also failed to take into account the fact that advisory firms already have stringent procedures in place to address potential conflicts relating to the personal investment activities of investment advisory personnel, including portfolio managers. Most mutual funds, for example, have procedures that require investment personnel to pre-clear personal securities transactions. In addition, the Institute, in its Report of the Advisory Group on Personal Investing,} [7] recommended, among other things, that mutual funds institute blackout periods, which prohibit a portfolio manager from buying or selling a security within at least seven calendar days before and

after an investment company that he manages trades in that security. The Report also recommended a ban on short-term trading profits. Substantially all fund groups have adopted the Institute's recommendations. In addition to these voluntary measures, funds must adhere to federal securities law requirements, particularly Rule 17j-1 under the Investment Company Act, which places restrictions on the personal investment activities of investment advisory personnel.

For these reasons, the Institute believes that NASDR should not seek to regulate the activities of portfolio managers under this proposal. If, however, NASDR determines that such persons should be subject to the proposal, it should, in recognition of the clear differences in the degree of potential conflicts of interest, revise the proposed disclosure requirements as they would apply to such individuals to reflect these differences. In particular, NASDR should require the disclosure of financial interests in a recommended security held in a discretionary account managed by an associated person only when those financial interests comprise over five percent of the account's portfolio holdings, rather than requiring disclosure of any such interest no matter how small. This change would appropriately limit the disclosure to those instances where the holdings might be viewed as significant enough to materially impact the fund's or account's performance.[8]

In addition, NASDR should not require the disclosure of the specific funds and/or discretionary accounts managed by an associated person that have a financial interest in a recommended security, but instead should only require a general statement about the financial interest. For example, a portfolio manager should be permitted to state only that one (or more) of the discretionary accounts that he manages has a financial interest in the recommended security. If this were not the case, disclosure by portfolio managers could be quite lengthy and of little use if several funds managed by such persons hold the recommended security. It also could force the disclosure of confidential information.

II. Scope and Use of the Term "Recommendation"

The disclosure requirements under the proposal would be triggered whenever there is a "recommendation." NASDR, however, has not defined the term "recommendation" for these purposes. The Institute believes that this term should be interpreted in a manner that is consistent with how NASDR has defined it in the past, and strongly urges NASDR to clarify this prior to adoption of the proposal.

Specifically, NASDR should clarify that a favorable comment by a portfolio manager during a public appearance regarding a security that is part of his fund's portfolio holdings would not be considered a "recommendation" of that security for purposes of the proposal.[9] Such a statement would not, at least by itself, be designed to promote transactions by individual investors in the particular security.

Interpreting the scope of the term "recommendation" in this manner would be consistent with previous NASDR guidance. In its recent Notice to Members on online suitability,[10] NASDR stated that the "facts and circumstances" test of whether a communication is a "recommendation" for purposes of the suitability rule requires an analysis of the content, context, and presentation of the particular communication and is an objective, rather than a subjective, inquiry. NASDR further stated that an important factor in this regard is whether—given its content, context, and manner of presentation—a particular communication reasonably would be viewed as a "call to action" or suggestion that the customer engage in a securities transaction. Clearly, under this analysis, a discussion by a portfolio manager of a security held in his fund's portfolio would not, in and of itself, be considered a "call to action" for individual investors to effect a transaction in that particular security. Accordingly, NASDR should clarify that, for purposes of this proposal, the term "recommendation" will be interpreted consistent with past NASDR guidance and that it would not apply to any favorable comment by a portfolio manager during a public appearance regarding a security that is part of his fund's portfolio holdings.

In addition, it is our understanding that NASDR has informally taken the position that disclosure of certain holdings of a mutual fund (or unit investment trust) in an advertisement or sales literature does not constitute a recommendation of those particular securities. We request clarification that NASDR will continue to take this position.

If, however, because of increased concerns in this area, NASDR intends the proposal to cover communications beyond those that have been traditionally considered recommendations (e.g., all favorable comments regarding a security), it is extremely important that NASDR revise the proposal and use a term other than "recommendation" to refer to those communications. Otherwise, there will be substantial confusion regarding the scope of other NASDR rules and guidance that employ that term. For example, it would be unclear whether the suitability determination required by NASD Rule 2310 in connection with any "recommendation" would now apply to a broader array of communications. We assume that NASDR does not intend such a result. (And, if it did, this should be the subject of a separate rule proposal.)

Accordingly, in order to avoid any confusion, if NASDR intends this proposal to apply to a broader range of communications, it should use a term other than "recommendation." We note that NASDR, in recognition of the potential implications of broadening the meaning of the term "recommendation," took a similar approach in the case of its rules relating to the opening of day-trading accounts.[11] We believe the same consideration should be applied to the present proposal.

III. Requested Clarifications

If the final rule does apply to portfolio managers, NASDR should clarify its application in the case of mutual funds or other discretionary accounts with more than one portfolio manager. Specifically, in the case of a multi-manager fund, a portfolio manager should only be required to disclose information pertaining to that portion of the fund over which he has discretion.

In addition, we recommend that the proposal be modified to expressly clarify that ownership of a recommended security through a mutual fund (or other investment company) by an individual covered by the rule does not constitute a "financial interest" in a security that would have to be disclosed under the rule. Requiring NASD members and associated persons to look through a mutual fund to determine if the fund holds a recommended security would result in significant difficulties in complying with the rule.

* * *

We appreciate the opportunity to comment on this proposal. If you have any questions regarding our comments, please contact the undersigned at 202-326-5824 or Ari Burstein at 202-371-5408.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye
Director

Robert E. Plaze
Associate Director
Division of Investment Management

Securities and Exchange Commission

Thomas M. Selman
Senior Vice President
Investment Companies/Corporate Financing
Joseph P. Savage
Counsel
Investment Companies Regulation

Philip Shaikun
Assistant General Counsel
Office of General Counsel

NASD Regulation

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,598 open-end investment companies ("mutual funds"), 504 closed-end investment companies and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.991 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] NASD Notice to Members 01-45 (July 2001) ("Notice").

[3] For the sake of simplicity, and to track the language of the proposal as noted below, references in our letter to the term "portfolio manager" also include any other investment advisory personnel that would be subject to the proposal.

[4] Notice at Endnote 1.

[5] It is important to note that, in most instances, the only reason portfolio managers register with the NASD, and therefore become an associated person of a broker-dealer, is not to sell individual securities but rather to participate in fund marketing activities (e.g., when a portfolio manager goes on a "road show" to promote a new fund, his activities may trigger NASD registration requirements). It also should be noted that the NASD member of which these individuals would be associated persons would be the fund's distributor, which, in most cases and unlike a traditional broker-dealer, does not conduct any transactions in individual securities.

[6] The Institute does not have a position on whether NASDR's proposal is necessary or appropriate for broker-dealers and their associated persons. Even if it is, however, different considerations apply to portfolio managers.

[7] Report of the Advisory Group of Personal Investing, Investment Company Institute, May 9, 1994. The Report can be found on the Institute's website at http://www.ici.org/pdf/personal_investing.pdf.

[8] In proposing the requirements for member firm disclosure of ownership of five percent or more of the total outstanding shares of any class of securities of the recommended issuer, the NASD states that "the ownership threshold recognizes that an analyst or firm is less likely to be influenced in its recommendation where a firm has a relatively small stake in an issuer." We believe the same principle should be applied to the required disclosure of discretionary account holdings.

[9] Similarly, NASDR should clarify that an unfavorable comment in this type of situation would not be considered a "recommendation."

[10] NASD Notice to Members 01-23, Online Suitability, April 2001.

[11] In that proposal, NASDR determined to use the term "promoting" rather than "recommending." Securities Exchange Act Release No. 41875 (September 14, 1999), 64 FR 51165 (September 21, 1999).
