

proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2003-37, and should be submitted by April 24, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47590; File No. SR-NASD-2003-13]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc. Relating to Proposed Interpretive Material Regarding the Use of Investment Analysis Tools

March 28, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and rule 19b-4 thereunder,² notice is hereby given that on February 3, 2003, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in items I, II, and III below, which Items have been prepared by the NASD. On February 27, 2003, the NASD amended the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD proposes to adopt a new Interpretive Material ("IM") to NASD rule 2210(d)(2)(N), to allow NASD member firms to use certain investment analysis tools that show the probability that investing in specific securities or mutual funds may produce a desired result. The text of the proposed rule change is below. Proposed new language is in *italics*.⁴ *IM-2210-6. Requirements for the Use of Investment Analysis Tools*

(a) General Considerations

This Interpretive Material provides a limited exception to NASD Rule 2210(d)(2)(N).¹

No member may imply that NASD endorses or approves the use of any investment analysis tool or any recommendation based on such a tool. A member that intends to offer an investment analysis tool under this Interpretive Material (whether customers use the member's tool independently or with assistance from the member) must, at least 30 days prior to first use, (1) provide NASD's Advertising Regulation Department (Department) access to the investment analysis tool and (2) file with the Department any template for written reports produced by, or sales material concerning, the tool.² The member also

⁴ The Commission notes for purposes of clarification that all of the proposed rule language is new language. While some of the language appears in brackets, this does not signify language that is being removed, as is normally the case in proposed rule language that is published in the *Federal Register*.

¹ NASD rule 2210(d)(2)(N) prohibits NASD member firms from making predictions or projections of specific investment results to the public. In the past, the rule also had been interpreted as prohibiting members from providing customers access to investment analysis tools that show the probability that investing in specific securities or mutual funds will produce a desired result. This Interpretive Material allows member firms to offer such tools (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tools and related sales material in certain circumstances.

Rule 2210(d)(2)(N) does not prohibit, and this Interpretive Material does not apply to, automated educational tools that are hypothetical or general in nature. For instance, rule 2210(d)(2)(N) generally does not prohibit, and this Interpretive Material does not cover, portfolio-based planning tools that merely generate a suggested mix of asset classes, broad categories of securities or funds, or probabilities as to how classes of financial assets or styles of investing might perform.

² Sales material that members disseminate to the public must be in the same form in which it was submitted to NASD for review and approval. Members cannot redact or alter such sales material after receiving NASD approval and must file with the Department any modified version of the sales material, at least 30 days prior to first use of the modified version of the sales material.

must provide any supplemental information requested by the Department. If the Department requests changes to the investment analysis tool, written-report template or sales material, the member may not offer or use the tool, written-report template or sales material until all changes specified by the Department have been made by the member and approved by the Department. In addition, as in all cases, a member's compliance with this Interpretive Material does not mean that the member is acting in conformity with other applicable laws and rules. A member that offers an investment analysis tool under this Interpretive Material (whether customers use the member's tool independently or with assistance from the member) is responsible for ensuring that use of the investment analysis tool and all recommendations based on the investment analysis tool (whether made via the automated tool or a written report) comply with NASD's suitability rule (rule 2310), the other provisions of rule 2210, and the other applicable federal securities laws and Securities and Exchange Commission and NASD rules.

(b) Definition

For purposes of this Interpretive Material and any interpretation thereof, an "investment analysis tool" is 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 of and returns on particular investments.

(c) Use of Investment Analysis Tools and Related Written Reports and Sales Material

A member may provide an investment analysis tool (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tool and related sales material³ only if:

(1) the tool presents a range of probabilities that various investment outcomes might occur and does not state that a particular investment outcome will, in fact, occur;

(2) the tool prominently presents a fair and balanced representation of the range of possible investment outcomes

³ Sales material that contains only an incidental reference to an investment analysis tool (e.g., a brochure that merely mentions a member's tool as one of the services offered by the member) does not need to include the disclosures required by this Interpretive Material and does not need to be filed with the Department, unless otherwise required by another rule 2210 provision.

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See February 27, 2003 letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, and attachments ("Amendment No. 1"). The original proposed rule change was inadvertently submitted without page 5, and contained some technical deficiencies. In Amendment No. 1, the NASD removed pages 1-25 of the original filing and replaced them with new pages 1-25. The Commission did not require the NASD to re-file pages 26-230.

that the tool's algorithm determines have a reasonable probability of occurrence;⁴

(3) the tool uses a mathematical process that can be audited and reviewed;

(4) the member describes the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;

(5) the member explains that results may vary with each use and over time;

(6) the member describes the universe of investments considered in the analysis, explains how the tool determines which securities to select, discloses if the tool favors certain securities⁵ and, if so, explains the reasons for the selectivity, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and

(7) the member displays the following additional disclosure: "IMPORTANT: The projections or other information

⁴ The entire range of investment outcomes would encompass a range of numbers that, as a practical matter, cannot be calculated accurately. The IM therefore requires that the tool, written report of the tool's results or related sales material show the range of possible investment outcomes that the tool's algorithm determines have a reasonable probability of occurrence."

The tool, written report of the tool's results or related sales material must depict a "fair and balanced representation" of this range. A "fair and balanced representation" would include, at a minimum, the "upside," "downside" and "median" projections of estimated outcomes, but would not require a depiction of every outcome in between. Any representation that, in light of all the facts and circumstances, is misleading will not be considered a "fair and balanced representation" of the range. For example, the presentation of a range of possible outcomes skewed to depict only or to weigh in favor of positive market performance would not be a "fair and balanced representation" of the range. In this regard, whenever the tool, written report of the tool's results or related sales material shows an outcome that the investor has a certain chance of achieving on the "upside," the tool, written report, or related sales material must also show the corresponding outcome on the "downside." Moreover, the tool, written report or related sales material should make clear that the dollar amount representing the "downside" is not the worst-case scenario, and it must include a prominent statement of the estimated probability (for example, a "5% chance" or "1 in 20 chance") that the investor will end up with less than the "downside" amount that the tool generates.

⁵ This disclosure must indicate, among other things, whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered based on revenue received by the member in connection with the sale of those securities or based on relationships or understandings between the member and the entity that created the investment analysis tool. The disclosure also must indicate whether the investment analysis tool is limited to searching, analyzing or in any way favoring securities in which the member makes a market or has any other direct or indirect interest. Members are not required to provide a "negative" disclosure (i.e., a disclosure indicating that the tool does not favor certain securities).

generated by [name of investment analysis 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 investment analysis tool] only presents a range of possible outcomes."

(d) Disclosures

The disclosures and other required information discussed in paragraph (c) must be written, clear and prominent.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in item IV below. The NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The NASD proposes to allow NASD member firms to use certain investment analysis tools that show the probability that investing in specific securities or mutual funds may produce a desired result. Under the proposed IM, members could offer investment analysis tools and written reports showing the results of such tools (and use related sales material) only if the tools, reports or sales material present a range of probabilities that various investment outcomes might occur and do not state that a particular investment outcome will, in fact, occur; present a fair and balanced representation of the range of possible investment outcomes that the tool's algorithm determines have a reasonable probability of occurrence; use a mathematical process that can be audited and reviewed; describe the criteria and methodology used, including the tool's limitations and key assumptions; explain that results may vary with each use and over time; and describe the universe of investments considered in the analysis, explain how the tool determines which securities to select, disclose if the tool favors certain securities and, if so, explain the reason for the selectivity, and state that other investments not considered may have

characteristics similar or superior to those being analyzed.

In addition, the following disclosure must be displayed: "Important: The projections or other information generated by [name of investment analysis 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 investment analysis tool] only presents a range of possible outcomes."

The proposed IM also would require members to provide NASD's Advertising Regulation Department with access to the tool (as well as any template for written reports showing the results of the tool or sales material concerning such tool) at least 30 days prior to first use. The review and approval are not merit-based, but rather focus on whether the member has complied with the disclosure requirements and the other requirements of NASD rule 2210, such as the prohibitions on exaggerated, unwarranted and misleading statements and claims. Finally, the IM makes clear that, to the extent that these tools produce recommendations, the NASD's suitability rule would apply.

2. Statutory Basis

The NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6)⁵ of the Act, which requires, among other things, that the NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. As discussed above, the proposed IM requires members to disclose various material aspects of the investment analysis tools and reports that they generate. The proposed IM also would require members to provide access to the tool (as well as any template for written reports showing the results of the tool or sales material concerning such tool) to the Advertising Regulation Department at least 30 days prior to first use. In addition, the proposal reminds firms of their suitability obligations. The NASD believes that these restrictions will enable firms to provide investment analysis tools to investors while making clear to investors the limitations of such tools. As such, the investment analysis tools should allow investors to make educated judgments about how particular strategies or investments might perform.

⁵ 15 U.S.C. 78o-3(b)(6).

B. Self-Regulatory Organization's Statement on Burden on Competition

The 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 Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

The proposed IM was published for comment in NASD *Notice to Members* 02-51 (August 2002). Fifty-six comments were received in response to the *Notice*. A copy of the *Notice to Members* is attached as Exhibit 2. Copies of the comment letters received in response to the *Notice* are attached as Exhibit 3. Of the 56 comment letters received, 50 were generally in favor of allowing members to provide customers access to investment analysis tools and five were opposed. (One of the comments received was non-responsive.) Numerous commenters noted that other financial service providers have used these types of tools for years without any customer confusion.

The NASD both clarified and modified certain aspects of the IM as a result of some of the comments that it received. For instance, a number of commenters requested that the NASD clarify the types of tools that rule 2210(d)(2)(N) currently prohibits and that would be eligible for the IM's limited exception. The IM 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. Such tools would be permitted under the proposed IM if they adhere to the IM's requirements. The revised proposed IM also states that rule 2210(d)(2)(N) does not prohibit and the proposed IM thus does not apply to automated educational tools that are hypothetical or general in nature. Rule 2210(d)(2)(N), for example, generally does not prohibit and the proposed IM does not cover portfolio-based planning tools that merely generate a suggested mix of asset classes, broad categories of securities or funds, or probabilities regarding how classes of financial assets or styles of investing might perform.

Some commenters also requested that the NASD broaden the IM to include an exception for written reports indicating the results of the tools' analyses, which the NASD did not expressly discuss in the proposed IM that was distributed for

comment. In general, these commenters opined that members should be able to provide reports to customers so that the customers have the opportunity to review the results and to ask follow-up questions or otherwise consult with a registered representative about the results. The IM now provides such an exception. Members may provide customers with such written reports if they fulfill the requirements set forth in the IM for members' use of the tools, including the first-use filing requirement, which could be accomplished by filing a template with the NASD (rather than by filing each individual report).

In addition, a number of commenters who reviewed the IM that previously was published for comment asked for clarification of the provision that required members to "prominently disclose the range of all possible investment outcomes generated by the investment analysis tool." In general, the commenters stated that providing a range of "all possible outcomes" would be cumbersome, confusing and impractical given the number of variables. Indeed, one commenter opined that it would be virtually impossible to depict all possible outcomes. Several commenters suggested that members should not be required to provide the range of all possible outcomes, but rather the range of outcomes that can be determined with a high degree of certainty.

In response to these comments, the NASD modified the provision. The IM explains that the entire range of investment outcomes would encompass a range of numbers that, as a practical matter, cannot be calculated accurately. The IM therefore requires a "fair and balanced representation" of the range of possible investment outcomes that the tool's algorithm determines have a "reasonable probability of occurrence." For example, a range of outcomes for which there is at least a one in 20 chance of occurrence on both the "upside" of the range and on the "downside" of the range would be deemed a range of outcomes that have a "reasonable probability of occurrence." This requirement will allow tools to eliminate the statistically insignificant outcomes (for example, those for which there is less than a one in 20 chance of occurrence), while still guaranteeing that the tool will show a range of likely investment outcomes that illustrates the relationship between risk and return. The tool should measure the outcomes that have a "reasonable probability of occurrence" with adequate precision to ensure a high degree of confidence in their accuracy.

However, the tool, written report of the tool's results or related sales material must depict a "fair and balanced representation" of this range. A "fair and balanced representation" would include, at a minimum, the "upside," "downside" and "median" projections of estimated outcomes, but would not require a depiction of every outcome in between. Any representation that, in light of all the facts and circumstances, is misleading will not be considered a "fair and balanced representation" of the range. For example, the presentation of a range of possible outcomes skewed to depict only or to weigh in favor of positive market performance would not be a "fair and balanced representation" of the range. In this regard, whenever the tool, written report of the tool's results or related sales material shows an outcome that the investor has a certain chance of achieving on the "upside," the tool, written report or related sales material must also show the corresponding outcome on the "downside." Moreover, the tool, written report or related sales material should also make clear that the dollar amount representing the "downside" is not the worst-case scenario, and it must include a prominent statement of the estimated probability (for example, a "5% chance" or "one in 20 chance") that the investor will end up with less than the "downside" amount that the tool generates.

III. Date of Effectiveness of the Proposed Rule Change and Timing For Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the NASD consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. The Commission specifically seeks comment on whether the fund advertising rules or any other Commission rules are implicated by the use of the investment analysis tools described in this proposed rule change. Persons making

written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-2003-13 and should be submitted by April 24, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁶

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47587; File No. SR-NASD-2000-42]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to Requirements for Recording and Reporting of Certain Quotation Data; Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1, 2, and 3 to the Proposed Rule Change

March 27, 2003.

I. Introduction

On July 3, 2000, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to establish requirements for the recording and reporting of certain quotation data. On October 5, 2000, the proposed rule change was published for

comment in the **Federal Register**.³ The Commission received one comment letter in response to the proposed rule change.⁴ The NASD responded to the comment letter and amended the proposed rule change on January 4, 2001.⁵ On June 14, 2001, the NASD submitted a letter clarifying a limitation on its proposed use of quotation data submitted in response to the proposed rule.⁶ On September 21, 2001, the NASD further amended its proposed rule change by filing Amendment No. 2.⁷ On February 27, 2003, the NASD filed Amendment No. 3 to its proposed rule change.⁸ This notice and order solicits comment on Amendment Nos. 1, 2 and 3 and approves the proposed rule change, as amended, on an accelerated basis.

II. Description of Proposed Rule Change

According to the NASD, in September 1999, the Electronic Pink Sheets ("EPS") began displaying real-time, on-line stock quotations for approximately 5,000 securities, including over-the-counter ("OTC") equity securities. Prior to the availability of EPS, quotations were published weekly in hardcopy lists known as the "pink sheets." These lists were updated via daily facsimile

³ See Securities Exchange Act Release No. 43367 (September 27, 2000), 68 FR 59482.

⁴ See letter from R. Cromwell Coulson, Chairman and CEO, Pink Sheets LLC ("Pink Sheets") to Jonathan G. Katz, Secretary, Commission, dated October 26, 2000 ("Pink Sheets Letter").

⁵ See letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated January 4, 2001 ("NASD Response to Comments and Amendment No. 1"). NASD Response to Comments and Amendment No. 1: (1) Addressed comments submitted by Pink Sheets; and (2) amended the proposed rule's text to clarify the conditions under which a member would be required to withdraw its quotations for non-compliance with the proposed rule's requirements.

⁶ See letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division, Commission, dated June 14, 2001 ("NASD Letter"). The NASD Letter clarified that quotation data provided to the NASD pursuant to the proposed rule would not be provided to The Nasdaq Stock Market, Inc.

⁷ See letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, to Nancy J. Sanow, Assistant Director, Division, Commission, dated September 21, 2001. ("Amendment No. 2"). In Amendment No. 2, the NASD revised the proposed rule's text to state expressly that the rule would not apply to quotations on inter-dealer quotation systems operated by a registered securities association or national securities exchange.

⁸ See letter from Stephanie M. Dumont, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated February 26, 2003. ("Amendment No. 3"). The amendment clarified that the NASD will not use an inside bid and/or offer that is calculated and submitted by the Reporting Agent for any commercial purposes.

transmission to subscribers. To obtain more current quotations for securities published in the pink sheets, market participants would communicate directly with broker-dealers publishing quotations in that medium, including unpriced indications of interest for the particular security.

NASD Regulation represents that because quotations for OTC equity securities now are displayed on a real-time basis in inter-dealer quotation systems, such as the pink sheets, NASD Regulation staff requires access to data pertaining to those quotations in order to surveil adequately for member compliance with applicable rules and regulations and, when necessary, to reconstruct market activity.

Therefore, the NASD proposed NASD Rule 6630 to require its members to: (1) Record specified information pertaining to quotations for OTC equity securities displayed in an inter-dealer quotation system⁹ that permits real-time quotation updates, unless such system is operated by a registered securities association, a national securities exchange or an NASD member; (2) preserve the quotation information for the period of time and accessibility set forth in Rule 17a-4(a) under the Act;¹⁰ and (3) report the quotation information to the NASD upon request.

Under the proposed rule, NASD members that publish quotations in inter-dealer quotation systems covered by the rule ("covered quotation systems") would be required to record, among other things, the time of the quotation's display, the bid price and quotation size, the offer price and quotation size, and the prevailing inside bid and offer in the quotation system at the time of the quotation.¹¹ The proposed rule would apply to priced quotes and unpriced indications of interest. The NASD proposal would permit members to enter into an agreement with a third party that would act as the agent for fulfilling the member's obligations under the rule.

NASD Regulation represents that it would use quotation data obtained pursuant to the proposed rule to surveil,

⁹ Rule 15c2-11(e) of the Act defines inter-dealer quotation system as "any system of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers." 17 CFR 240.15c2-11(e).

¹⁰ 17 CFR 240.17a-4(a). Pursuant to Rule 17a-4(a) under the Act, members would be required to preserve records of such data for at least six years. During the first two of the six years, members would be required to maintain the records "in an easily accessible place."

¹¹ See Amendment No. 3, *supra* note 8, which clarifies that a member should not consolidate quotation information from other systems or markets that are quoting the security.

⁶ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.