

## ACTION REQUESTED BY AUGUST 15, 2001

## Required Disclosures For Securities Recommendations

NASD Regulation Requests Comment On Proposed Amendments To Rule 2210, Communications With The Public; **Comment Period Expires August 15, 2001**

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

## KEY TOPICS

- Analyst Disclosures
- Communication With The Public

## Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) requests comment from National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) members, investors, and other interested parties on a proposed amendment to NASD Rule 2210, Communications with the Public, that would strengthen disclosures required when a member recommends a security in written advertisements and sales literature. The proposed amendment also would require, for the first time, similar disclosures for recommendations made by a research analyst or other associated person during a public appearance. The proposal would define public appearance to include radio or television interviews, seminars, and interactive electronic forums.

For both written recommendations and those made during public appearances, the proposed rule amendment generally would require an associated person or firm to disclose that (1) the analyst responsible for the recommendation has a personal financial interest in the recommended security; (2) the member firm owns five percent or more of the outstanding shares of any class of security of the recommended issuer; and (3) the member firm has received compensation from the issuer of the security for investment banking services. The proposed amendment would further require that all applicable disclosures in advertisements and sales literature be made specifically and prominently (*i.e.*, that they not consist of boilerplate at the end of a research report or in a footnote).

Included with this *Notice* is Attachment A, the text of the proposed rule amendment.

This proposal represents a first step to address issues related to the quality and independence of research and recommendations issued by firms and associated persons. NASD Regulation continues to consider potential additional policies in this area to enhance investor protection.

## Request For Comment

NASD Regulation requests comment on the proposed amendment. Comments must be received by **August 15, 2001**. Members and interested persons can submit their comments using the following methods:

- mailing in the checklist (Attachment B)
- mailing in written comments
- e-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com)
- submitting comments online at the NASDR Web Site ([www.nasdr.com](http://www.nasdr.com))

If you decide to submit comments using both the checklist and one of the other methods listed above, please indicate that in your submissions. The checklist and/or written comments should be mailed to:

*Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, DC 20006-1500*

The only comments that will be considered are those submitted in writing, either via e-mail or regular mail, or those submitted online through the NASD Regulation Web Site.

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Before becoming effective, the NASD Regulation Board of Directors must adopt, and the Securities and Exchange Commission must approve, any rule change. The NASD Board of Governors also may review the rule change.

### Questions/Further Information

As noted, written comments should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice to Members—Request For Comment* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, at (240) 386-4533; Joseph P. Savage, Counsel, Investment Companies Regulation, at (240) 386-4534; or Philip Shaikun, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8071.

### Background

This proposed rule amendment is the result of ongoing efforts to address the potential conflicts of interest presented by analyst recommendations. To address these concerns, the proposed rule change would require more meaningful, understandable, and conspicuous disclosures of these potential conflicts of interest in both written and oral recommendations. NASD Regulation believes that heightened disclosure by analysts will increase transparency for investors who consider analyst recommendations as part of their decision to purchase, sell, or hold a security.

In December 2000, the NASD Regulation Board of Directors authorized NASD Regulation staff to work with the staffs of the

Securities and Exchange Commission and other organizations to develop uniform disclosure standards for securities recommendations by financial services firms and their employees. The Board felt strongly that, in order to best protect investors, such standards should apply to all financial services providers on an equal basis.

Given the need to address these problems, however, NASD Regulation has determined to take this step and propose disclosure standards applicable to NASD member firms and their associated persons. NASD Regulation continues to believe that uniform standards should apply to all securities professionals. NASD Regulation welcomes comment from interested parties on the scope of persons and firms that should be subject to the types of disclosure requirements that are discussed in this *Notice* and contained in the proposed rule text.

Currently, NASD Rule 2210(d)(2)(B), Communications with the Public, requires certain disclosures when a member makes a security recommendation in advertisements and sales literature. However, those rules do not apply when similar recommendations are made during public appearances, such as radio and television interviews. The proposed rule amendment would strengthen the disclosures required in advertisements and sales literature that contain recommendations. It also would extend similar disclosure requirements for public appearances, appropriately tailored to recognize the practical constraints of making disclosures in radio, television, and similar forums.

### Disclosures In Advertisements And Sales Literature

NASD Rule 2210(d)(2)(B) currently requires members to disclose, when applicable, in advertisements and sales literature

1. that the member makes a market in the securities being recommended, or in the underlying security if the recommended security is an option, or that the member or associated persons will sell or buy the recommended security from customers on a principal basis;
2. that the member or its officers or partners own options, rights or warrants to purchase any securities of the recommended issuer (unless the extent of such ownership is nominal);
3. that the member was manager or co-manager of any public offering of the recommended issuer's securities within the last three years;
4. information supporting the recommendation (or to offer to furnish such information upon request);
5. for corporate equities, the price at the time the recommendation was made; and
6. when presenting past recommendations, all of the member's or associated person's recommendations for similar securities and time periods.

Notably, the current rule does not require an analyst or member firm to disclose ownership interest in a recommended equity security; rather, it only requires a member to disclose if an officer, partner or the member firm owns *options*,

*rights or warrants* to purchase any of the recommended issuer's securities. To strengthen these disclosures, the proposed rule amendment would add several additional requirements.

First, the proposal would require the person or persons responsible for a recommendation to disclose *any* financial interest that they have in a recommended security. We would like to receive comment on whether and to what extent the nature of that financial interest (including, but not limited to, ownership of [or short positions in] stock, options, rights, warrants and futures) should be disclosed. This disclosure obligation also would apply to any discretionary account managed by the person or persons responsible for the recommendation.<sup>1</sup>

Second, the proposal would require member firms to disclose if they own five percent or more of the total outstanding shares of any class of securities of the recommended issuer. 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. The five percent threshold is consistent with Sections 13(d) and 13(g) of the Securities Exchange Act of 1934, which requires broker/dealers, among others, to notify the SEC whenever they own five percent or more of any class of registered securities. Furthermore, since those filings are public, the information should be readily available to associated persons who make recommendations either in writing or during public appearances.

NASD Regulation requests comment on this five percent ownership threshold for firm ownership of the issuer's shares.

NASD Regulation staff specifically seeks comments as to whether a lower threshold – or no threshold at all – would be more appropriate. Should this threshold be set, for example, at three percent or one percent?

Third, the proposed amendment would eliminate the requirement to disclose that the member managed or co-managed within the last three years a public offering by the issuer of the recommended security. Instead, the proposal would require disclosure that the member has received compensation from the recommended issuer for any investment banking services provided to the issuer within the last 12 months. This proposed change recognizes the fact that, in addition to acting as underwriters, investment banks today provide a variety of advisory and other financial services to issuers for which they receive compensation. It also limits the time frame that triggers the disclosure to one more likely to give rise to a conflict of interest.

NASD Regulation requests comment on this approach. In particular, NASD Regulation seeks comment on whether, in addition to disclosure of "an investment banking relationship," members should be required to describe the specific *nature of the services* for which compensation has been received from the issuer within the prior year. Disclosure of the specific nature of the investment banking services rendered would give investors more detailed information to assess the relationship between the analyst's firm and the issuer and thus may assist investors in putting recommendations in a broader context. NASD Regulation solicits comment on whether this additional, more detailed

disclosure is desirable or would create unintended or unforeseen consequences.

Finally, the proposal would mandate that all required disclosures in advertisements and sales literature be made *specifically and prominently*. This language is intended to prohibit the use of boilerplate in footnotes and other inconspicuous locations in advertisements and sales literature, so that investors can more readily ascertain the existence and degree of any potential conflicts of interest. To that end, NASD Regulation would expect the type size of required disclosures to be no smaller than the body of the document itself and in close proximity to the securities recommendation. NASD Regulation also considers the clarity of the language and the intended audience when assessing whether disclosure meets a prominence standard.

### **Disclosures During Public Appearances**

The proposed amendment also would require analysts to provide similar disclosures when a security is recommended during a public appearance. The proposal defines public appearance as "participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity." The amendment would require associated persons who make recommendations during public appearances to disclose any financial interest held by that person or any discretionary account he or she manages; ownership by the firm of five percent or more of the total outstanding shares of any class of equity securities or the issuer; and that the issuer is "a client of the firm with which the [person

recommending the security] is associated.” The term “client” means an issuer from which the firm has received compensation for investment banking services provided to the issuer within the last 12 months.

Notably, none of the other six requirements for written recommendations contained in current Rule 2210(d)(2)(B) (and listed above) would apply to recommendations during public appearances. The staff believes that the more narrow disclosures for public appearances contained in the proposed rule change strike a reasonable balance between meaningful disclosure and the practical limitations imposed during short television interviews and similar public appearances. NASD Regulation specifically seeks comment on whether disclosures in a public appearance should be broader or should include one or more of the six disclosures outlined above for written materials. In addition, similar to the proposal for written materials, the current proposal as it applies to public appearances would not require disclosure of the *nature* of the investment services provided. NASD Regulation solicits comments on whether the nature of the services provided should be disclosed in public appearances. In considering these issues, however, commenters should keep in mind the practical constraints imposed on public appearances in comparison to written materials of the firm. Comment is also requested on the level of firm ownership calling for disclosure.

### Endnote

- 1 The proposed rule would apply to portfolio managers of investment companies and other discretionary accounts only in those instances where those managers are also associated persons of an NASD member.

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**ATTACHMENT A****Proposed Amendment to Rule 2210(d)(2)(B) Recommendation Provisions**

*Proposed new rule text is underlined; proposed deleted rule text is bracketed.*

**(B) Recommendations.**

(i) Advertisements and sales literature. In making a recommendation in advertisements and sales literature, whether or not labeled as such, a member must have a reasonable basis for the recommendation and must specifically and prominently disclose any of the following situations which are applicable:

a. that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option, or that the member or associated persons will sell to or buy from customers on a principal basis;

b. that [the member and/or its officers or partners own] any officer or partner of the member owns options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;

c. that the member [was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years.] has received compensation from the recommended issuer for investment banking services provided to the issuer within the last twelve months;

d. that the person or persons principally responsible for the recommendation, or any discretionary account managed by such person or persons, has a financial interest in any security of the recommended issuer, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position); and

e. that the member owns (or through the exercise of options or warrants would own) 5 percent or more of the total outstanding shares of any class of equity securities of the recommended issuer.

(ii) Public appearances. In any public appearance, an associated person making a recommendation (whether or not labeled as such) must disclose any of the following situations which are applicable:

a. that the recommended issuer is a client of the member with which the person is associated;

b. that the associated person, or any discretionary account managed by such person, has a financial interest in any security of the recommended issuer, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position); and

c. that the member owns (or through the exercise of options or warrants would own) 5 percent or more of the total outstanding shares of any class of equity securities of the recommended issuer.

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“Public appearance” consists of participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity.

(iii) [(ii)] With respect to recommendations in advertisements and sales literature, the member shall also provide, or offer to furnish upon request, available investment information supporting the recommendation. Recommendations on behalf of corporate equities must provide the price at the time the recommendation is made.

(iv) [(iii)] A member may use material referring to past recommendations if it sets forth all recommendations as to the same type, kind, grade or classification of securities made by a member within the last year. Longer periods of years may be covered if they are consecutive and include the most recent year. Such material must also name each security recommended and give the date and nature of each recommendation (e.g., whether to buy or sell), the price at the time of the recommendation, the price at which or the price range within which the recommendation was to be acted upon, and indicate the general market conditions during the period covered.

(v) [(iv)] Also permitted is material which does not make any specific recommendation but which offers to furnish a list of all recommendations made by a member within the past year or over longer periods of consecutive years, including the most recent year, if this list contains all the information specified in subparagraph (iv) [(iii)]. Neither the list of recommendations, nor material offering such list, shall imply comparable future performance. Reference to the results of a previous specific recommendation, including such a reference in a follow-up research report or market letter, is prohibited if the intent or the effect is to show the success of a past recommendation, unless all of the foregoing requirements with respect to past recommendations are met.

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## ATTACHMENT B

### Request For Comment Checklist

We have provided below a checklist that members and other interested parties may use in addition to or in lieu of written comments. This checklist is intended to offer a convenient way to participate in the comment process, but does not cover all aspects of the proposal described in the *Notice*. We therefore encourage members and other interested parties to review the entire *Notice* and provide written comments, as necessary.

### Instructions

Comments must be received by **August 15, 2001**. Members and interested parties can submit their comments using the following methods:

- mailing in this checklist
- e-mailing written comments to *pubcom@nasd.com*
- mailing in written comments
- submitting comments online at the NASDR Web Site (*www.nasdr.com*)

The checklist and/or written comments should be mailed to:

*Barbara Z. Sweeney*  
*Office of the Corporate Secretary*  
*NASD Regulation, Inc.*  
*1735 K Street, NW*  
*Washington, DC 20006-1500*

### Proposed Amendments to Rule 2210, Communications With The Public

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1. Should associated persons and their firms be required to disclose potential conflicts of interest when recommending a security in a television, radio, or other public appearance?  
 Yes    No    See my attached written comments
2. If you answered “yes” to number 1, is the definition of “public appearance” in the proposed rule appropriate?  
 Yes    No    See my attached written comments
3. Should the same disclosure rules apply to recommendations made during public appearances as for recommendations in advertisements and sales literature?  
 Yes    No    See my attached written comments

4. Should members and associated persons who make securities recommendations have to disclose that the firm has received compensation for investment banking services provided to the issuer within the last 12 months?  
 Yes    No    See my attached written comments
5. If you answered “yes” to 4, is it sufficient disclosure during a public appearance to state only that the issuer of the recommended security is a “client” of the firm?  
 Yes    No    See my attached written comments
6. Should members and associated persons who make securities recommendations have to disclose the nature of investment banking services for which the firm has received compensation from the issuer of the recommended security during the past 12 months?  
 Yes    No    See my attached written comments

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7. Should the person or persons responsible for a recommendation have to disclose that he or she has a financial interest in a recommended security?
- Yes  No  See my attached written comments
8. Should the person or persons responsible for a recommendation have to disclose that a discretionary account they manage has a financial interest in a recommended security?
- Yes  No  See my attached written comments
9. Should the person or persons responsible for a recommendation have to disclose the nature of a financial interest that they, or discretionary accounts they manage, have in the recommended security?
- Yes  No  See my attached written comments
10. Should a member have to disclose an ownership interest of five percent or more of the total outstanding shares of any class of equity securities of a recommended issuer?
- Yes  No  See my attached written comments
11. Should a member have to disclose an ownership interest of less than five percent of the total outstanding shares of any class of equity securities of a recommended issuer?
- Yes  No  See my attached written comments

### Contact Information

Name: \_\_\_\_\_

Firm: \_\_\_\_\_

Address: \_\_\_\_\_

City/State/Zip: \_\_\_\_\_

Phone: \_\_\_\_\_

E-Mail: \_\_\_\_\_

### Are you:

An NASD Member

An Investor

A Registered Representative

Other: \_\_\_\_\_