WILMER, CUTLER & PICKERING

Securities Law Developments NEWSLETTER

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SEC Approves NASD Overhaul of Member Public Communications Rules and Clarifies the Status of Instant Messaging

On May 9, 2003, the Securities and Exchange Commission approved a National Association of Securities Dealers, Inc. ("NASD") proposal to modernize and simplify its rules governing member communications with the public.[1] Initially proposed in 1999 and first filed with the Commission in 2000, these amendments provide significant relief from the skyrocketing burdens of complying with public communications rules designed for a pre-Internet world.[2] The amendments take effect on November 3, 2003. After giving with one hand, however, the NASD took back with the other. In a separate Notice to Members issued the following month, the NASD clarified that instant messages are to be treated like e-mail for supervision and retention purposes.[3]

As a result:

Institutional Sales Literature. Communications with specified types of institutional investors will be exempt from pre-approval and filing requirements, as well as certain content standards.[4]

Group E-mails and Form Letters. Group e-mails and form letters to existing retail customers and fewer than 25 prospective retail customers in a 30-day period will be exempt from pre-approval and filing requirements, as well as certain content standards.

Instant Messaging. Members must retain, review, and otherwise supervise instant messages.

I. Institutional Sales Material

Material that is made available only to specified types of institutional investors ("institutional sales material") will not be subject to NASD supervisory pre-approval or filing requirements. In addition, certain content standards will not apply to institutional sales material. Members will nonetheless have to establish written supervisory procedures covering institutional sales material.

A. Covered Institutions

Under new Rule 2211, institutional sales material means any communication that is distributed or made available only to institutional investors. The new

1 *See Order Approving Proposed Amendments to Rules Governing Member Communications With the Public*, Release No. 34-47820 (May 9, 2003), 68 Fed. Reg. 27,116 (May 19, 2003), *available at* http://www.nasdr.com/pdf-text/rf00_12_app.pdf.

2 The full text of the amendments is available at http://www.nasdr.com/pdf-text/rf00_12_a04.pdf (Letter from Philip Shaikun, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (Mar. 6, 2003)).

3 NASD Notice to Members 03-33 (July 2003), *available at* http://www.nasdr.com/pdf-text/0333ntm.pdf.

4 Please note that New York Stock Exchange Rule 472 does not exempt institutional sales literature from supervisory pre-approval, and the Exchange has given no indication that it plans to amend its rules to include such an exemption.

definitions of advertisements and sales literature exclude institutional sales material. An institutional investor means:

- any person described in NASD Rule 3110(c)(4),which includes:
    - a bank, savings and loan association, insurance company, or registered investment company;
    - a registered investment adviser; or
    - a person or other entity with total assets of at least $50 million;
- a governmental entity or subdivision thereof;
- certain employee benefit plans or qualified plans, provided that the plan has at least 100 participants;
- any NASD member or registered associated person of an NASD member; or
- any person acting solely on behalf of an institutional investor.

A member will not be able to treat a communication as having been distributed only to institutional investors if the member has "reason to believe that the communication or any excerpt thereof will be forwarded or made available to any person other than an institutional investor." Members intending to rely on the institutional sales material carve-out may want to consider obtaining agreements or using disclaimers prohibiting redistribution to any persons who are not institutional investors as defined in Rule 2211.

B. Content Standards for Institutional Sales Material

Institutional sales material, like all communications with the public, will be subject to certain basic content requirements. Under amended Rule 2210, the basic content standards, applicable to all communications with the public, are as follows:

- Communications must follow principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts relating to a security, industry, or service. A member must not omit a material fact or qualification if such omission would cause the communication to be misleading.
- Communications must not include any false, exaggerated, unwarranted, or misleading statement or claims.
- Information may be placed in a legend or footnote only if doing so does not inhibit the investor's understanding of the communication.
- Predictions and projections of performance are prohibited, although hypothetical illustrations are permitted if they do not predict or project performance.
- A testimonial regarding a technical aspect of investing may only be used if the person making the testimonial has the knowledge and experience to form a valid opinion.

Institutional sales material will, however, be exempt from other content requirements, including:

- specific disclosures relating to testimonials;
- disclosure of all material differences between investments or services that are being compared;
- prominent disclosure of the member's name and requirements regarding the inclusion of other names;
- disclosures relating to recommendations;
- restrictions on the use of investment company rankings; and
- standards relating to collateralized mortgage obligations.

C. Supervision of Institutional Sales Material and Other Required Procedures

Under the amended rules, members will be required to establish supervisory procedures regarding institutional sales material. These procedures must:

- be in writing;
- be appropriate to the member's business, size, structure, and customers;
- provide for a registered principal to review institutional sales material used by the member and its registered representatives;
- be designed to reasonably supervise registered representatives; and
- either:
    - require pre-use review of all institutional sales material, or

- provide for (i) the education and training of associated persons as to the member's procedures, (ii) documentation of education and training, and (iii) surveillance and follow-up to ensure effective implementation of the procedures.[5]

Members must maintain evidence that they have implemented these procedures and must provide this evidence to the NASD upon request.

Institutional sales material will remain subject to the NASD spot-check requirement, which requires members to submit written and electronic communications with the public to the NASD's Advertising Regulation Department upon request.

II. Group E-mail and Form Letters

A. Framework

In the past, the NASD has taken the position that any e-mail or letter sent to more than one person is sales literature. Under the amendments, most group e-mail and form letters will be deemed to be correspondence. Specifically, "correspondence" is defined as any written letter or e-mail message that a member distributes to one or more of its existing retail customers and to fewer than 25 prospective retail customers within any period of 30 calendar days. An "existing retail customer" means any person who is not an institutional investor and:

- for whom the member, or a clearing broker or dealer on behalf of the member, carries an account, or
- who has an account with any registered investment company for which the member serves as principal underwriter.

A "prospective retail customer" is any person who is not an existing retail customer or an institutional investor. Correspondence is expressly excluded from the definition of sales literature. If material is used as sales literature, however, a member will not be able to convert it to correspondence by enclosing it with a piece of correspondence.

B. Content Standards

Correspondence, while subject to the basic content standards applicable to all communications with the public (see Section I.B above), will be exempt from certain other content requirements, including:

- specific disclosures relating to testimonials;
- disclosure of all material differences between investments or services that are being compared;
- disclosures relating to recommendations;
- required disclosures and other requirements related to the use of investment company rankings, except for limitations on the categories and subcategories upon which such rankings may be based; and
- standards relating to variable life insurance and variable annuities.

Unlike institutional sales material, correspondence must prominently disclose the member's name and, if it includes other names, reflect the member's relationship to these other names and reflect which services or products the member is offering.

C. Other Standards

Pre-approval and filing requirements, applicable to sales literature and advertisements, will not apply to correspondence. The supervision requirements of NASD Rule 3010(d) remain applicable, however, as do the record-keeping procedures of NASD Rule 3110. Correspondence also will remain subject to the NASD spot-check requirement. Moreover, "[t]he NASD encourages members to consider whether to adopt stricter procedures that require registered principal pre-use approval of Group Correspondence that presents a higher risk to investors, based on factors such as its content, purposes or targeted audience."[6]

III. Instant Messaging

Instant messaging is an increasingly popular technology that allows users to exchange brief text messages in real time. Although their informality and

5 These requirements are similar to the general requirement to review correspondence relating to a member's investment banking or securities business, as prescribed in NASD Rule 3010(d)(2).

6 68 Fed. Reg. at 27,118.

format make instant messages resemble telephone conversations, the NASD announced in Notice to Members 03-33 that instant messages are equivalent to e-mail messages. As such, members must retain instant messages that relate to their businesses and must review and supervise those messages. Somewhat surprisingly, the notice further indicates, without explanation, that instant messages could be deemed sales literature, and thus be subject to supervisory pre-approval and filing requirements. It is unclear whether these requirements can be efficiently reconciled with the benefits of a real-time electronic communication technology like instant messaging. Indeed, the NASD acknowledged in the notice that many members have simply prohibited personnel from using it and indicated that members must take this course if they are unable to establish adequate procedures for supervision, review, and retention of instant messages.[7]

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7 The New York Stock Exchange also has taken the position that member organizations must retain instant messages relating to their businesses, but the Exchange has not specifically addressed supervision of instant messages. *See* NYSE Information Memo 03-07 (March 2003).