

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