MEMO# 35516

November 28, 2023

FINRA Proposes Amendments to Rule 2210 Related to Performance Projections; Comments Due by December 15

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TO: Accounting/Treasurers Committee
Advertising Compliance Advisory Committee
Investment Advisers Committee
Sales and Marketing Committee
SEC Rules Committee
Small Funds Committee RE: FINRA Proposes Amendments to Rule 2210 Related to Performance Projections; Comments Due by December 15

Earlier this month, FINRA filed with the SEC proposed amendments to Rule 2210 (Communications with the Public) (the "rule").[[1]] If adopted, the amendments would permit a FINRA member to project the performance or provide a targeted return with respect to a security or asset allocation or other investment strategy in an institutional communication (or a communication distributed solely to qualified purchasers that promotes or recommends specified non-public offerings), subject to several investor protection-oriented conditions.

Comments are due to the SEC by December 15. ICI will comment on the proposal, and we will be discussing it with members on our Advertising Compliance Advisory Committee call on December 6 at 2:00 pm ET. If you are interested in joining this call, please register here: https://cvent.me/Q4yL51.

Background

In 2017, FINRA issued a Regulatory Notice requesting comment on proposed amendments to the rule.[[2]] Notwithstanding the rule's general prohibition on communications that predict or project performance,[[3]] the 2017 proposal would have permitted customized hypothetical investment planning illustrations that project performance of an asset allocation or other investment strategy (but not an individual security), subject to specified conditions.[[4]]

ICI's comment letter generally supported FINRA's 2017 proposal, which we believed could help inform customers' investment decision-making process.[[5]]

Summary of the 2023 Proposal

This proposal is substantially different from the 2017 iteration, although to varying degrees both would provide additional flexibility for FINRA members to provide performance projections. FINRA describes the 2023 proposal as creating "a new, narrowly tailored, exception to the general prohibition of projections."[[6]]

The 2023 proposal would permit "[a] communication that projects the performance or provides a targeted return with respect to a security or asset allocation or other investment strategy," subject to several conditions. This new provision would be limited to: (i) institutional communications, or (ii) communications that are distributed or made available only to "qualified purchasers"[[7]] and that promote or recommend specified non-public offerings.[[8]]

This new exception also would require:

- The member to adopt and implement written policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication and to ensure compliance with all applicable requirements and obligations;[[9]]
- The member to have a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return, and retaining written records supporting the basis for these criteria and assumptions;
- The communication to prominently disclose that the projected performance or targeted return is hypothetical in nature and that there is no guarantee that the projected or targeted performance will be achieved; and
- The member to provide sufficient information to enable the investor to understand:
  - the criteria used and assumptions made in calculating the projected performance or targeted return, including whether the projected performance or targeted return is net of anticipated fees and expenses;[[10]] and
  - the risks and limitations of using the projected performance or targeted return in making investment decisions, including reasons why the projected performance or targeted return might differ from actual performance.

In connection with the proposed "reasonable basis" requirement mentioned above, proposed Supplementary Material 2210.01 would require members to consider multiple enumerated factors, with none being determinative. It lists 13 factors[[11]] and also states that members may not base projected performance or a targeted return upon (i) hypothetical, back-tested performance, or (ii) the prior performance of a portfolio or model that was created solely for the purpose of establishing a track record.

The proposal also notes the following:

- These communications "must meet Rule 2210's general standards, including the requirements that communications be fair and balanced, provide a sound basis for evaluating the facts in regard to any particular security or type of security, and not contain false, exaggerated, unwarranted, promissory or misleading content."[[12]]
- Members' supervisory procedures would need to include the review of these new

communications.

- "[I]f a member relies on third-party models or software to create a projection or targeted return, the member would be expected to establish and maintain a supervisory system reasonably designed to ensure that any projections or targeted returns created by a third-party vendor are used consistently with the proposed rule change's requirements."[[13]]

Finally, the proposal compares its terms to those of FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools) and the hypothetical performance standards of the SEC's investment adviser marketing rule (Rule 206(4)-1 under the Investment Advisers Act).

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Notes

[[1]] Notice of Filing of a Proposed Rule Change To Amend FINRA Rule 2210 (Communications With the Public) To Permit Projections of Performance of Investment Strategies or Single Securities in Institutional Communications; SEC Release No. 34-98977, 88 Fed. Reg. 82482 (Nov. 24, 2023) (the "proposal"), available at https://www.govinfo.gov/content/pkg/FR-2023-11-24/pdf/2023-25881.pdf.

[[2]] FINRA Requests Comment on Proposed Amendments to Rules Governing Communications with the Public, FINRA Regulatory Notice 17-06 (February 2017), available at: www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-06.pdf. See Institute Memorandum No. 30584, dated February 16, 2017, for a more detailed summary of the 2017 proposal.

[[3]] Rule 2210(d)(1)(F) prohibits communications that "predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast," subject to specific exceptions for: a hypothetical illustration of mathematical principles, provided that it does not predict or project the performance of an investment or investment strategy; an investment analysis tool, or a written report produced by an investment analysis tool, that meets the requirements of Rule 2214; and a price target contained in a research report on debt or equity securities, subject to certain conditions.

[[4]] Specifically, the illustration would have required a "reasonable basis" and certain disclosures, and would be subject to supervisory requirements.

[[5]] Available at https://www.finra.org/sites/default/files/notice_comment_file_ref/17-06_ICI_comment.pdf. We recommended that the proposal be enhanced further by: (i) removing the "customization" requirement; and (ii) providing guidance regarding the precise scope of the proposed and existing exceptions to the rule's general prohibition on projections, so that members can put them to wider and better use (e.g., in educational materials).

[[6]] Proposal at 82483. "The general prohibition against performance projections is intended to protect investors who may lack the capacity to understand the risks and limitations of using projected performance in making investment decisions." Id. at 82482.

[[7]] The proposal would rely on the Investment Company Act's definition of this term.

[[8]] Specifically, "either a Member Private Offering that is exempt from the requirements of Rule 5122 pursuant to Rule 5122(c)(1)(B), or a private placement that is exempt from the requirements of Rule 5123 pursuant to Rule 5123(b)(1)(B)."

[[9]] Moreover, "such a communication should only be distributed where the member reasonably believes the investors have access to resources to independently analyze this information or have the financial expertise to understand the risks and limitations of such presentations." Id. at 82484.

[[10]] "Firms would be expected…to provide a general description of the methodology used sufficient to enable the investors to understand the basis of the methodology, as well as the assumptions underlying the projection or targeted return." Id. at 82485.

[[11]] The 13 factors are: "(1) Global, regional, and country macroeconomic conditions; (2) Documented fact-based assumptions concerning the future performance of capital markets; (3) In the case of a single security issued by an operating company, the issuing company's operating and financial history; (4) The industry's and sector's current market conditions and the state of the business cycle; (5) If available, reliable multi-factor financial models based on macroeconomic, fundamental, quantitative, or statistical inputs, taking into account the assumptions and potential limitations of such models, including the source and time horizon of data inputs; (6) The quality of the assets included in a securitization; (7) The appropriateness of selected peer-group comparisons; (8) The reliability of research sources; (9) The historical performance and performance volatility of the same or similar asset classes; (10) For managed accounts or funds, the past performance of other accounts or funds managed by the same investment adviser or sub-adviser, provided such accounts or funds had substantially similar investment objectives, policies, and strategies as the account or fund for which the projected performance or targeted returns are shown; (11) For fixed income investments and holdings, the average weighted duration and maturity; (12) The impact of fees, costs, and taxes; and (13) Expected contribution and withdrawal rates by investors." The proposal notes that some of these proposed factors come from the CFA Institute's discussion of Standard V in the Institute's Standards of Practice Handbook.

[[12]] Id. at 82485-82486.

[[13]] Id. at 82486.