



Financial Industry Regulatory Authority

October 31, 2011

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-FINRA-2011-035 – Response to Comments

Dear Ms. Murphy:

On July 14, 2011, FINRA filed with the Securities and Exchange Commission (“SEC” or “Commission”) SR-FINRA-2011-035, a proposed rule change to adopt NASD Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-3 through 2210-8 as FINRA Rules 2210 and 2212 through 2216, and to delete paragraphs (a)(1), (i), (j) and (l) of Incorporated NYSE Rule 472, Incorporated NYSE Rule Supplementary Material 472.10(1), (3), (4) and (5) and 472.90, and Incorporated NYSE Rule Interpretations 472/01 and 472/03 through 472/11. The Commission published the proposed rule change for comment in the Federal Register on August 3, 2011.¹ The Commission received nine comment letters in response to the proposed rule change.² This letter responds to those comments.

¹ See Securities Exchange Act Release No. 64984 (July 28, 2011), 76 FR 46870 (August 3, 2011) (Notice of Filing of SR-FINRA-2011-035) (“Proposing Release”). The comment period closed on August 24, 2011.

² See Letter from Oscar S. Hackett, General Counsel, BrightScope, Inc., dated August 23, 2011 (“BrightScope”); letter from Alexander C. Gavis, Fidelity Investments, dated August 24, 2011 (“Fidelity”); letter from David T. Bellaire, Esq., General Counsel and Director of Government Affairs, Financial Services Institute, dated August 24, 2011 (“FSI”); letter from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, dated August 24, 2011 (“ICI”); letter from Z. Jane Riley, CSCP, Chief Compliance Officer, The Leaders Group, Inc., dated August 24, 2011 (“TLGI”); letter from Peter J. Mougey, President, Public Investors Arbitration Bar Association, dated August 23, 2011 (“PIABA”); letter from John Polanin and Claire Santaniello, Co-Chairs, Compliance and Regulatory Policy Committee 2011, Securities Industry and Financial Markets Association, dated August 25, 2011 (“SIFMA”); letter from Sandra J. Burke, Principal, Vanguard, dated August 24, 2011 (“Vanguard”); and letter from Yoon-Young Lee, WilmerHale, on behalf of Citigroup Global Markets Inc., Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., JP Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. LLC, and UBS

Definitions

The proposed rule change would replace the current six communication categories with three new categories: institutional communication, retail communication, and correspondence.³ “Institutional communication” would mean any written (including electronic) communication that is distributed or made available only to institutional investors. “Retail communication” would mean any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. Correspondence would mean any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period. “Institutional investor” generally would include the same persons (subject to certain clarifying changes) that are included in the current definition of “institutional investor” under NASD Rule 2211.⁴ “Retail investor” would mean any person other than an institutional investor, regardless of whether the person has an account with a member.

Definition of Institutional Investor

Fidelity recommended that the definition of “institutional investor” be revised to cover any size retirement plan (including those with fewer than 100 participants) and that it cover any type of retirement plan, including those that do not meet the requirements of Sections 403(b) or 457 of the Internal Revenue Code and are not qualified plans as defined in the Exchange Act. Fidelity argued that the 100-participant minimum is arbitrary given that there is no correlation between plan size and investor sophistication, and that this standard is difficult to administer in practice because it requires firms to track the number of participants in clients’ retirement plans. Fidelity further argued that the retirement plans’ coverage under the Employee Retirement Income Security Act of 1974 provides sufficient protection to small

Securities LLC, dated August 26, 2011 (“Wilmer”). (Available at <http://www.sec.gov/comments/sr-finra-2011-035/finra2011035.shtml>.)

³ See proposed FINRA Rule 2210(a).

⁴ See NASD Rule 2211(a)(3). The current definition of “institutional investor” includes, among other persons, an employee benefit plan that meets the requirements of Section 403(b) or Section 457 of the Internal Revenue Code, or a qualified plan as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934 (“Exchange Act”), in either case where the plan has at least 100 participants. The proposed new definition of “institutional investor” would clarify that the term includes multiple employee benefit plans and multiple qualified plans offered to employees of the same employer, provided that the plans in the aggregate have at least 100 participants.

retirement plans without having to treat them as retail investors for purposes of FINRA communications rules.

The proposed term “institutional investor” also includes any person described in FINRA Rule 4512(c) (the definition of “institutional account” for purposes of the rules governing members’ books and records), regardless of whether the person has an account with a member. The term “institutional account” includes, among other persons, any natural person or entity not included within the other persons described in the definition of “institutional account” with total assets of at least \$50 million. Fidelity recommended that this asset threshold be decreased to \$5 million in order to make the definition of “institutional investor” more consistent with SEC Regulation D. SIFMA similarly recommended that the definition be expanded to include unregistered hedge funds, money managers and family offices, regardless of the assets under management. Alternatively, SIFMA recommended that the asset threshold be reduced to \$10 million.

The proposed definition of “institutional investor” also states that no member may treat a communication as having been distributed to an institutional investor if the member “has reason to believe that the communication or any excerpt thereof will be forwarded or made available to any retail investor.” The FSI stated that FINRA needs to set parameters around this expectation, given that the “reason to believe” standard is subject to a variety of interpretations. SIFMA recommended that FINRA replace this standard with a requirement that a member establish policies and procedures (such as the use of legends that prohibit the forwarding of material to retail investors) that are reasonably designed to limit the distribution of communications to institutional investors.

FINRA believes that the proposed definition of “institutional investor” is appropriate and does not require amendment. FINRA previously made a determination that retirement plans with fewer than 100 participants should receive the same investor protections as other retail investors, whereas larger plans typically have greater resources to hire advisers that can assist them in their investment decisions. While it may be true that some plans with 100 or more participants have no more investment sophistication than a smaller plan, FINRA does not believe that this argument leads to the conclusion that all plans should be treated as institutional investors. Fidelity has not identified any provision in ERISA or any Department of Labor rule under that Act that is intended to provide the same protections to investors with regard to communications with the public as are provided to retail investors under Rule 2210. Fidelity also has not identified the types of plans other than those described in the definition that it believes should be included as institutional investors. Accordingly, FINRA declines to broaden the universe of retirement plans that are included.

FINRA also does not believe it is appropriate to lower the minimum asset threshold for investors that are not included in another institutional investor category.

FINRA believes that the definition of institutional investor is already sufficiently broad to include a wide range of persons, and does not need to be expanded even further. Moreover, FINRA is seeking to harmonize, where appropriate, the definitions related to institutional investors under its rules; creating a different asset threshold for the definition of “institutional investor” under Rule 2210 would run counter to this goal.

A firm’s policies and procedures are among the factors FINRA will consider in determining whether a firm has reason to believe an institutional communication will be forwarded to retail investors. However, FINRA disagrees that the mere existence of policies and procedures designed to prevent the forwarding of communications to retail investors (such as legends placed on communications) is sufficient to meet this standard. For example, FINRA would not consider a firm to have met this standard if it merely places a legend on a communication warning the recipient not to forward it to retail investors, and a registered representative then orally tells the recipient to distribute the communication as he pleases. In addition, FINRA does not believe a firm should be able to treat a communication as an institutional communication in circumstances where, notwithstanding policies and procedures, the firm becomes aware that previous similar communications have been routinely redistributed to retail investors. Accordingly, FINRA declines to change this standard from the current rule.

Definitions of Retail Communication and Correspondence

TLGI argued that the definition of correspondence is too limited, and that the definition of retail communication is too broad. TLGI recommended that FINRA instead consider all communications to existing retail customers to be correspondence. SIFMA recommended that the definitions of these terms be qualified to state that the 25-person cutoff is determined by the number of persons to whom a member or associated person directly distributes a communication (and thus does not include persons to whom such recipients forward the communication).

FINRA disagrees that the term correspondence should include all communications to existing retail customers. The term is intended to allow greater supervisory flexibility for communications sent to a limited number of recipients. FINRA has also included in the proposal a number of other exceptions that allow firms to supervise certain types of retail communications similarly to correspondence, such as retail communications posted on an online interactive electronic forum, and retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the member, irrespective of the number of recipients.

FINRA believes, however, that retail communications to large numbers of retail investors (regardless of whether they are existing customers) that include financial or investment recommendations or otherwise promote the products or services of the member should receive additional scrutiny. Accordingly, FINRA does

not believe it would be appropriate to expand the definition of correspondence as TLGI recommends.

FINRA agrees that a member generally is not responsible for a third party that independently forwards a retail communication to additional recipients. However, FINRA does not believe that the definitions of retail communication or correspondence should be revised to state this principle, since such matters will always be determined by the facts and circumstances surrounding a particular communication.

Approval, Review and Recordkeeping

Proposed FINRA Rule 2210(b)(1)(A) generally requires an appropriately qualified registered principal to approve each retail communication before the earlier of its use or filing with FINRA's Advertising Regulation Department ("Department"). The rule also includes a number of exceptions and modifications to this requirement for certain types of retail communications. In addition, proposed paragraph (b)(1)(E) authorizes FINRA to grant an exemption from paragraph (b)(1)(A) for good cause shown, to the extent the exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest.

Proposed paragraph (b)(1)(B) would permit a supervisory analyst approved pursuant to NYSE Rule 344 to approve research reports on debt and equity securities. Wilmer recommended that this provision be revised to permit supervisory analysts to review and approve any communication produced by a firm's research department, including communications that are not research reports on debt or equity securities. Wilmer gave as examples macroeconomic research or research on commodities.

FINRA does not believe that this change is necessary or appropriate. Proposed paragraph (b)(1)(D)(i) already would allow members to supervise certain types of retail communications in the same manner as correspondence. These communications include any retail communication that is excepted from the definition of "research report" pursuant to NASD Rule 2711(a)(9)(A), which includes "commentaries on economic, political or market conditions." To the extent a research department produces communications concerning other types of investments, such as commodities, FINRA believes that a principal with appropriate expertise, rather than a supervisory analyst, should review such communications.

The SEC staff noted that currently market letters are treated as correspondence.⁵ Under NASD Rule 2211, if correspondence is distributed to 25 or more existing retail customers within any 30 calendar-day period and makes a

⁵ Market letters are defined as "any written communication excepted from the definition of 'research report' pursuant to [NASD] Rule 2711(a)(9)(A)." See NASD Rule 2211(a)(5).

financial or investment recommendation or otherwise promotes a product or service of the member, it must be approved by a principal prior to use.⁶ The staff inquired whether under proposed FINRA Rule 2210(b)(1)(D)(i) a principal would have to approve a retail communication that is excepted from the definition of “research report” pursuant to NASD Rule 2711(a)(9)(A) prior to use if it contained a financial or investment recommendation. FINRA did intend for such retail communications to be subject to principal pre-use approval, and has amended proposed paragraph (b)(1)(D)(i) accordingly.

Wilmer alternatively argued that FINRA should exclude from the principal pre-use approval requirements all communications produced by a firm’s research department. FINRA disagrees. The fact that a particular department within a firm produces a communication generally should not alter the manner in which the communication is reviewed and supervised. As such, FINRA believes the current rules and proposal appropriately focus on the nature of the communication, not the source of origin.

Proposed FINRA Rule 2210(b)(1)(D)(iii) would allow a member to supervise in a manner similar to correspondence any retail communication that does not make any financial or investment recommendation or otherwise promote a product or service of the member. TLGI argued that this exception from the principal pre-use approval requirements is not defined concretely enough. In contrast, PIABA recommended that this exception include only retail communications that are solely administrative in nature. Wilmer requested confirmation that research-authored educational pieces, such as primers on certain asset classes that do not recommend specific securities, are excepted from the principal pre-use approval requirements under this provision.

In the version of the proposed rule change that was published for comment in Regulatory Notice 09-55, FINRA proposed to except from the principal pre-use approval requirements retail communications that are solely administrative in nature. At that time, numerous commenters argued that this standard was unclear and insufficient. In response to these comments, FINRA revised the standard to except from principal pre-use approval retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the member. FINRA believes that this revised standard is clearer as to its scope than the prior standard, and accordingly, is not inclined to either return to the prior standard or revise it further.

FINRA does not agree that so-called “educational” pieces are generally excepted from the principal pre-use approval requirements under this provision. While this determination will always depend on the facts and circumstances, the

⁶ See NASD Rule 2211(b)(1)(A).

purpose of such pieces may be to draw investor interest to a member's products and services, and accordingly would be viewed as promotional in nature.

The ICI recommended that, should FINRA grant exemptive relief from the principal pre-use approval requirements to a member or a small number of members pursuant to proposed paragraph (b)(1)(E), FINRA should announce this relief in a Regulatory Notice and simultaneously grant this relief to all members. FINRA plans to consider the best means to publish any relief granted under this provision. However, FINRA generally does not intend to use this provision to grant similar relief to firms that have not applied for it. Should FINRA determine that similar relief is appropriate for all members, it generally expects to file a proposed rule change with the SEC to accomplish this result.

Proposed paragraph (b)(4)(A)(i) would require members to maintain a copy of each member communication and the dates of first and (if applicable) last use of such communication. Wilmer requested confirmation that the requirement to maintain the date of last use does not apply to research communications. This requirement (if applicable) applies to all communications; there is no exception for research.

Filing Requirements and Review Procedures

Proposed FINRA Rule 2210(c)(1) through (c)(3) would require members to file certain retail communications either at least 10 business days prior to first use or publication, or within 10 business days of first use or publication, depending on the communication. While most of these filing requirements are found in current NASD Rule 2210, the proposed rule change would add certain new filing categories, such as retail communications concerning closed-end funds that are published or distributed after the initial public offering ("IPO") period closes, and retail communications concerning any registered security that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency, that is not included in other filing requirements ("retail structured products"). Proposed paragraph (c)(7) includes a number of exclusions from these filing requirements.

Filing Requirements

TLGI expressed concern that the filing requirements of paragraph (c)(3) would subject almost all member communications to filing with FINRA. FINRA disagrees. First, the filing requirements under this paragraph cover retail communications concerning registered investment companies, public direct participation programs, investment analysis tools, collateralized mortgage obligations, and retail structured products. The filing requirements would not cover correspondence or institutional communications. They also would not apply to retail communications concerning many other types of securities that are not listed in that paragraph.

Wilmer argued that the proposed filing requirements for retail communications concerning government securities or registered structured products would greatly expand the filing obligations with regard to many types of research communications, with little benefit to investors. SIFMA similarly argued that FINRA should maintain the current filing requirements for government securities and closed-end funds, since principal pre-use approval is sufficient, and FINRA staff review on a post-use basis does not add investor protection, since the material is already distributed.

After careful consideration, FINRA has determined to eliminate the proposed filing requirement for retail communications concerning government securities. Under NASD Rule 2210, members are required to file advertisements concerning government securities. This requirement has generated relatively few filings over the past few years, and FINRA staff has found relatively few problems with the advertisements that have been filed. Given the potential burden that an expanded filing requirement for retail communications concerning government securities may impose on members as compared to the relatively lower risk that such retail communications pose, FINRA believes that it is not necessary to require members to file these communications. FINRA still retains the ability to review such communications through other means, such as spot checks or targeted examinations, and to take appropriate actions against members for violations of FINRA rules.

FINRA disagrees with the argument that post-use review by FINRA staff fails to protect investors. FINRA allows members to file communications on a post-use basis as a way to prevent filing requirements from serving as an impediment to distributing sales material in a timely manner. The solution to the problem that SIFMA suggests would be to require that all retail communications be filed prior to use. While FINRA would require pre-use filing for certain types of retail communications that it believes present potentially higher risks to investors, FINRA believes that post-use filing is sufficient for many other types of retail communications. These filing requirements provide a check on firms that may otherwise consider including misleading statements in sales material, and brings potentially misleading material to FINRA's attention in a timely manner.

In addition, FINRA also disagrees with the argument that there is no need to file research concerning retail structured products. In a recent report summarizing broker-dealer examinations by the staff of the SEC Office of Compliance Inspections and Examinations, SEC staff found a number of sales-related problems concerning structured products sold to retail investors. In particular, the staff found that some free-writing prospectuses concerning principal protected notes failed to disclose risks that investors could receive less than the principal investment if these notes were redeemed prior to maturity. There were also problems regarding disclosures of fees for some products.⁷ Accordingly, FINRA believes that retail communications

⁷ Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, "Staff Summary Report on Issues Identified in

concerning retail structured products should be filed for review by FINRA staff to help ensure that they are not misleading.

Exclusions from Filing Requirements

Proposed paragraph (c)(7)(B) would exclude from the filing requirements retail communications that are based on templates that were previously filed with the Department, the changes to which are limited to updates of more recent statistical or other non-narrative information. Fidelity recommended that this filing exclusion be expanded to cover updates of narrative information that is sourced from either an independent data provider or an investment company or its affiliate. The ICI and SIFMA recommended that this filing exclusion should be expanded to cover updates of narrative factual information from an entity that provides general information about investment companies to the public and is independent of the investment company and its affiliates.

FINRA does not agree with Fidelity's suggestion, since such a filing exclusion would encompass almost all retail communications concerning investment companies, as long as a new retail communication could be related to a previously filed communication. FINRA also has considered the expansion recommended by the ICI and SIFMA, but has determined not to make the recommended change. FINRA is concerned about the types of narrative information that would be updated, such as changes to the description of a fund's investment objectives, and believes that in some cases additional review by Department staff may be warranted for updates of such narrative information.

Proposed paragraph (c)(7)(F) would exclude from the filing requirements prospectuses, preliminary prospectuses, fund profiles, offering circulars and similar documents that have been filed with the SEC or any state, or that is exempt from such registration, except that an investment company omitting prospectus under Securities Act Rule 482 and a free-writing prospectus that has been filed with the SEC pursuant to Securities Act Rule 433(d)(1)(ii) will not be considered a prospectus for purposes of this exclusion. SIFMA argued that this filing exclusion should cover all free-writing prospectuses that are widely distributed, since they are already filed with the SEC.

FINRA disagrees that the filing exclusion under proposed paragraph (c)(7)(F) should cover all widely distributed free-writing prospectuses that have been filed with the SEC. The filing requirement would apply to any free writing prospectus that is used or referred to by an offering participant, other than the issuer of securities, and distributed by or on behalf of such person in a manner reasonably designed to lead to

its broad unrestricted dissemination.⁸ FINRA has found through its investigations of sales material for retail structured products that some widely distributed free-writing prospectuses for such products that been prepared by or on behalf of an offering participant, such as an underwriter of securities, have misleading content that merits review by the Department. Accordingly, FINRA believes that this additional review of such widely distributed free-writing prospectuses will help protect investors from potentially misleading sales material.

Nevertheless, FINRA acknowledges that prospectuses, preliminary prospectuses, fund profiles and similar documents filed with the SEC, other than investment company omitting prospectuses published pursuant to Securities Act 482 or free-writing prospectuses filed with the SEC pursuant to Securities Act 433(d)(1)(ii), are not subject to the content standards of proposed FINRA Rule 2210(d). Accordingly, FINRA has proposed to add a new paragraph (d)(8) to FINRA Rule 2210 that clarifies this point.

Proposed paragraph (c)(7)(H) would exclude from the filing requirements press releases made available only to members of the media. Fidelity and SIFMA recommended that this exclusion be expanded to cover all materials that are provided to the media, such as white papers, research reports, charts, and educational materials. The ICI alternatively argued that the proposed rule should treat communications provided solely to the media as correspondence.

FINRA declines to expand the filing exclusion for press releases made available only to members of the media to include other types of communications. To the extent a member is using a media outlet to distribute retail communications other than press releases, FINRA believes that such retail communications should be filed with the Department for review if they are subject to a separate filing requirement; otherwise, the media could become a conduit by which firms could potentially avoid those filing requirements. In addition, whether a communication to a member of the media is correspondence, a retail communication or an institutional communication will depend on the facts and circumstances. FINRA does not believe it makes sense to characterize all such communications as correspondence.

Proposed paragraph (c)(7)(L) would exclude from the filing requirements communications that refer to types of investments solely as part of a listing of products or services offered by the member. The ICI supported this filing exclusion, but noted that “it seemingly would apply to, among other documents, a retirement plan enrollment guide, which includes a listing of a plan’s investment options.” The ICI’s understanding is correct only to the extent an enrollment guide listed the types of

⁸ See 17 C.F.R. § 230.433(d)(1)(ii). The filing requirement does not apply to a free writing prospectus prepared by or on behalf of the issuer of securities. See 17 C.F.R. §§ 230.433(d)(1)(i) and 230.433(h)(1).

investments available through the plan. To the extent an enrollment guide mentioned the individual funds or other investment options available through a plan, this filing exclusion would not be available.

SIFMA recommended that FINRA add a new filing exclusion for retail communications posted on an online interactive electronic forum, similar to the exception from the principal pre-use approval requirements under proposed FINRA Rule 2210(b)(1)(D)(ii).⁹ FINRA disagrees that there should be a filing exclusion for such retail communications. To the extent an online interactive electronic forum is used to promote specific securities, FINRA believes that such retail communications should be filed for the same reasons as any other retail communication that is subject to a filing requirement: to allow FINRA to monitor compliance with the content and other standards for certain products and by certain firms. If members are concerned about online forums being used to post retail communications that are subject to a filing requirement, FINRA believes the better approach would be to adopt policies and procedures that prohibit associated persons from posting these types of communications.¹⁰

Content Standards

Projections of Performance

Proposed FINRA Rule 2210(d)(1)(F) generally would prohibit communications from predicting or projecting performance, implying that past performance will recur, or making any exaggerated or unwarranted claim, opinion or forecast. This provision would not prohibit: (i) a hypothetical illustration of mathematical principles, provided that it does not predict or project the performance of an investment or investment strategy; (ii) an investment analysis tool, or a written report produced by such a tool, that meets the requirements of proposed FINRA Rule 2214; or (iii) a price target contained in a research report on debt or equity securities that meets certain standards. Wilmer requested confirmation that proposed paragraph (d)(1)(F) would not apply to communications produced by a member's research department.

Proposed paragraph (d)(1)(F) would apply to all communications, including those produced by a member's research department. However, FINRA does not believe that this prohibition would inhibit the types of content typically found in

⁹ SIFMA also stated that "the better solution" would be to revise proposed FINRA Rule 2210(f) to specify that online postings are a type of public appearance that do not constitute retail communications. This comment is discussed later in this letter.

¹⁰ See also Regulatory Notice 10-06 (January 2010), fn. 8.

research communications. The provision includes an exception expressly permitting price targets that meet the standards of NASD Rule 2711. In addition, FINRA does not believe that the type of content described by Wilmer, such as forward-looking statements or earnings estimates commonly provided in research reports, would be considered projections of performance for purposes of this provision. In general, this provision is intended to prohibit specific percentage or dollar-based projections of performance of an investment. Nevertheless, proposed paragraph (d)(1)(F) would prohibit research communications from including any exaggerated or unwarranted claim, opinion or forecast.

Tax Considerations

Proposed FINRA Rule 2210(d)(4) imposes certain content standards and disclosure requirements on certain retail communications and correspondence that discuss tax considerations of investments and investment accounts. TLGI commented that the disclosure requirements regarding tax considerations are very complicated and should be limited to a requirement to disclose that an investor should seek professional tax advice due to the complexity and changing nature of the tax code.

FINRA disagrees with this recommendation. FINRA believes that the disclosures listed in proposed paragraph (d)(4) are important to help an investor understand the context and limitations of communications that discuss tax implications of investments and investment accounts. FINRA cautions against any member preparing a communication that it believes may be inaccurate due to the complexity of tax laws and rules.

The SEC staff inquired whether FINRA intended to require such retail communications to disclose that ordinary tax rates apply to withdrawals from tax-deferred investments. Because FINRA does intend to require this disclosure in illustrations of tax-deferred products or accounts to the extent withdrawals are subject to ordinary income tax rates, it has revised proposed paragraph (d)(4) to clarify this point.

Disclosure of Fees, Expenses and Standardized Performance Information

Proposed FINRA Rule 2210(d)(5) generally carries forward certain disclosure requirements concerning investment company fees and expenses with respect to retail communications and correspondence that advertise a fund's performance.¹¹ The ICI opposed the proposed requirement that certain standardized performance and expense information be included in a prominent text box with respect to print advertisements that include fund performance. The ICI argued that a simple prominence requirement should suffice.

¹¹ See NASD Rule 2210(d)(3).

FINRA disagrees with this recommendation. Prior to the adoption of NASD Rule 2210(d)(3), FINRA found that some mutual fund print advertisements placed standardized performance information in footnotes while placing non-standardized performance information in the body of a print advertisement, despite equal prominence requirements contained in Securities Act Rule 482. FINRA has found that NASD Rule 2210(d)(3) has helped clarify that placing performance information in footnotes does not meet the equal prominence requirements of Rule 482, and made print performance advertisements more fair and balanced. Accordingly, it is not inclined to eliminate the print advertisement text box requirements of proposed FINRA Rule 2210(d)(5).

Recommendations of Securities

Proposed FINRA Rules 2210(d)(7) and 2210(f)(1) would require retail communications and public appearances that include a recommendation of securities to have a reasonable basis for the recommendation, and to make certain disclosures. Among other things, a retail communication or a public appearance that includes a recommendation of securities would have to disclose, if applicable, that the member or any associated person with the ability to influence the content of the communication has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), unless the extent of the financial interest is nominal. FINRA received a number of comments concerning these proposed requirements.

Fidelity and SIFMA recommended that the disclosure requirements apply only to public appearances and retail communications that are published or used in any electronic or other media. These commenters noted that it is not necessary to mandate extensive disclosure requirements for public appearances before small groups.

Fidelity and the FSI argued that the requirement to disclose the financial interests of any associated person with the ability to influence the content of the communication is unclear, too broad, and difficult to administer. Many persons within a firm may be able to influence a communication's content, and it would be difficult to track each person's financial interests with respect to particular retail communications or public appearances. Fidelity recommended that this disclosure requirement be limited to associated persons who are "directly and materially involved in the preparation of the content." The FSI questioned the need for this disclosure at all, which it considered to be "meaningless to the majority of retail investors."

SIFMA recommended that the requirement to disclose the financial interests of any associated person with the ability to influence the content of the communication be deleted and replaced with a requirement to disclose the financial interests of a member's officers or partners, which is similar to the current disclosure requirements

for securities recommendations in NASD IM-2210-1(6). SIFMA argued that this alternative would “provide meaningful disclosures to customers, without requiring members to implement costly monitoring systems and processes.”

On the other hand, PIABA urged FINRA to broaden the disclosure requirements for retail communications and public appearances that contain securities recommendations. This commenter argued that the proposed standard (associated persons with the ability to influence the content of a communication) is too narrow.

Fidelity and the ICI focused particular attention on the proposed disclosure requirements as they would apply to public appearances. These commenters argued that the proposed standard is unworkable in this context, particularly where a speaker is answering a question about a particular security, and that such appearances would be impossible to monitor. The ICI also argued that the standard is unfair, since it would impose disclosure requirements on registered representatives who recommend securities that are not imposed even on research analysts that recommend securities in public appearances.

Fidelity suggested as an alternative that the disclosure requirements of proposed FINRA Rule 2210(d)(7) apply to public appearances only if a member or associated person intends to recommend a security. The ICI offered as an alternative a more general requirement that an associated person making a public appearance disclose any actual, material conflict of interest related to a particular recommendation of which the person knows or has reason to know at the time of the public appearance. The ICI noted that this standard is similar to the public appearance requirements that apply to research analysts under NASD Rule 2711(h).

Fidelity recommended that FINRA clarify that the disclosure requirements in proposed FINRA Rule 2210(d)(7)(A)(ii) do not apply to indirect holdings, such as securities that are held by mutual funds or other pooled vehicles in which an associated person invests.

Proposed Rule 2210(d)(7)(D)(i) would except from these disclosure requirements any communication that meets the definition of “research report” or is a public appearance by a research analyst for purposes of NASD Rule 2711 and includes all of the applicable disclosures required by that Rule. Wilmer recommended that this exception be expanded to cover all communications created by a firm’s research department, including debt research and research related communications that are not research reports.

In response to these comments, FINRA has determined to amend the disclosure requirements for both retail communications and public appearances that include securities recommendations. As suggested by several commenters, FINRA is changing the scope of the persons whose financial interests would have to be disclosed. As revised, a retail communication that includes a securities

recommendation would have to disclose if the member or any associated person that is directly and materially involved in the preparation of the content of the communication has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal.

FINRA also modified paragraph (d)(7)(D) to clarify that the disclosure requirements in paragraph (d)(7)(A) and the provisions regarding past specific recommendations in paragraph (d)(7)(C) do not apply to a retail communication that recommends only registered investment companies or variable insurance products; however, such communications still must have a reasonable basis for the recommendation. In addition, pursuant to proposed paragraph (d)(7)(B), a member must provide, or offer to furnish upon request, available investment information supporting the recommendation.¹²

FINRA does not believe it is necessary to expressly exclude indirect holdings from the disclosure requirements in proposed FINRA Rule 2210(d)(7)(A)(ii). These requirements apply to any of the securities of the issuer whose security is being recommended in a retail communication that is held by the member or an associated person that is directly and materially involved in the preparation of the content of the communication. They do not apply to the portfolio investments of an investment company or other fund owned by the member or such an associated person.¹³

FINRA believes that this revised standard provides sufficient information to investors reading a retail communication to warn them of potential conflicts of interest. It also reduces the burdens on members with regard to tracking financial interests that must be disclosed.

FINRA is also revising the disclosure standards for public appearances that include securities recommendations. As revised, the requirements under proposed FINRA Rule 2210(f) would apply only to public appearances by associated persons (since members do not engage in public appearances except through their associated persons). In addition an associated person making a public appearance would have to disclose, if applicable, his or her own financial interests in any of the securities of the issuer of the recommended security, and the nature of the financial interest, unless the

¹² The proposed requirement in paragraph (d)(7)(B) to provide the price at the time a recommendation is made applies only to a recommendation of a corporate equity security, and thus does not apply to the recommendation of an investment company security or variable insurance product.

¹³ Moreover, the disclosure requirements do not apply to any communication that recommends only registered investment companies or variable insurance products. See proposed FINRA Rule 2210(d)(7)(D)(ii).

extent of the financial interest is nominal. The associated person also would have to disclose any actual, material conflict of interest of the associated person or member of which the associated person knows or has reason to know at the time of the public appearance. These disclosure requirements would not apply to any public appearance by a research analyst for purposes of NASD Rule 2711 that includes all of the applicable disclosures required by that Rule. The disclosure requirements also would not apply to a recommendation of investment company securities or variable insurance products; provided, however, that the associated person must have a reasonable basis for the recommendation. FINRA believes that this standard will still provide important information regarding potential conflicts to investors, while reducing the compliance burden to firms in administering this standard.

Other Public Appearance Issues

Proposed FINRA Rule 2210(f)(2) would require each member to establish written procedures that are appropriate to its business, size, structure and customers to supervise its associated persons' public appearances. The ICI opposed this proposed requirement as duplicative of supervisory requirements that already exist under NASD Rule 3010. FINRA disagrees with this objection. While it is true that NASD Rule 3010 already generally requires a member to establish and maintain written procedures to supervise its associated persons' activities,¹⁴ FINRA rules also include provisions regarding the supervision of particular activities where appropriate.¹⁵ In this case, FINRA believes that proposed FINRA Rule 2210(f)(2) provides additional information regarding the type of supervision it expects members to maintain in connection with public appearances, and thus is appropriate.

Under NASD Rule 2210, the term "public appearance" is included as a category within the broader term "communications with the public," and includes participation in an interactive electronic forum.¹⁶ Under proposed FINRA Rule 2210, public appearances would not be included within the broader term "communications," and instead would be governed by FINRA Rule 2210(f). The term also would not include posts on interactive electronic forums, which would be considered retail communications.

Fidelity and SIFMA opposed the elimination of the term "public appearance" as a communication category, particularly with respect to interactive electronic communications. These commenters argued that posts on interactive electronic

¹⁴ See NASD Rule 3010(b)(1).

¹⁵ See, e.g., FINRA Rule 2330(d) (supervisory procedures regarding the purchase or exchange of deferred variable annuities).

¹⁶ See NASD Rule 2210(a)(5).

forums are more analogous to “physical public appearances.” They also argued that recordkeeping requirements would be less burdensome if posts on social media websites are considered public appearances.

FINRA disagrees that it is necessary to continue to treat posts on interactive electronic forums as public appearances. FINRA has already created an exception from the principal pre-use approval requirements for such posts, permitting members to supervise and review such posts in the same manner permitted for correspondence.¹⁷ Moreover, this proposed standard would codify guidance already provided regarding supervision of posts on social media websites.¹⁸ Accordingly, FINRA does not believe it is either necessary or appropriate to include posts on interactive electronic forums within the provisions governing public appearances.

Internal Communications

Proposed FINRA Rule 2210.01 would provide that a member’s internal written (including electronic) communications that are intended to educate or train registered persons about the products or services offered by a member are considered institutional communications pursuant to proposed FINRA Rule 2210(a)(3), and thus are subject to both the applicable provisions of proposed FINRA Rule 2210 and NASD Rule 3010(d) (review of correspondence). Fidelity, the ICI, SIFMA and Vanguard all opposed including these types of internal communications within the definition of “institutional communication,” arguing that it would impose new compliance and supervisory requirements on internal communications that do not exist under current FINRA rules.

FINRA disagrees. The current definition of “institutional sales material” under NASD Rule 2211 includes any communication that is distributed or made available only to any NASD member or registered associated person of such a member.¹⁹ Moreover, FINRA has settled a number of enforcement actions against members involving misleading internal educational and training materials that alleged violations of NASD Rules 2210 and 2211.²⁰ Accordingly, FINRA believes that treatment of

¹⁷ See proposed FINRA Rule 2210(b)(1)(D)(ii).

¹⁸ See Regulatory Notice 10-06 (January 2010) and Regulatory Notice 11-39 (August 2011).

¹⁹ See NASD Rule 2211(a)(2) and (a)(3)(E).

²⁰ See, e.g., NASD Letter of Acceptance, Waiver and Consent No. EAF0401000001 (MML Distributors, LLC) (Oct. 2005); NASD Letter of Acceptance, Waiver and Consent No. EAF0401240001 (AFSG Securities Corp.) (Oct. 2005); FINRA Letter of Acceptance, Waiver and Consent No. 20080130571 (US Bancorp Investments, Inc.) (Feb. 12, 2010); and FINRA

internal educational or training material that relate to a member's products or services as institutional communications is consistent with current FINRA rules and FINRA's current and past interpretations of those rules.

Fidelity commented that, should this requirement be retained, it should also cover internal communications to associated persons who are not registered persons. FINRA does not believe this extension is necessary. FINRA is primarily concerned with ensuring that internal communications that are used in the sales process are fair, balanced and appropriately supervised. FINRA does not believe that it is necessary to cover other types of non-sales related internal communications, such as communications to non-registered associated persons.

Social Media

Fidelity, the ICI and Vanguard expressed concern with the amount of content and data related to social media that must be stored under SEC recordkeeping rules. These commenters recommended that the SEC, FINRA and the securities industry work together to create a new paradigm for electronic recordkeeping. The ICI and Vanguard also urged FINRA to take a longer-term, comprehensive approach to the regulation of social media that is based on a strong understanding of evolving media and technological capabilities, and that considers the costs and benefits of regulation. Fidelity recommended that FINRA use its Social Media Task Force or another committee to consider how the communications rules should apply to mobile devices and provide guidance or new rules that are tailored to these technologies. The FSI recommended that FINRA codify in its communications rules the guidance that it provided in Regulatory Notices 10-06 and 11-39.

While FINRA appreciates these suggestions regarding the application of the communications rules to social media and electronic devices, FINRA notes that the commenters' concerns regarding the SEC's recordkeeping rules are outside the scope of the proposed rule change. FINRA intends to continue to work with the industry going forward to address issues raised under FINRA rules, and may issue more guidance or propose new rules regarding these issues in the future as appropriate.

Other Issues

TLGI expressed its view that the proposed rule change will not improve the flow of communications, which in turn will compromise investor protection. FINRA disagrees. The proposed rule change seeks to balance the need for members to communicate with their customers and the need for such communications to be fair and balanced. FINRA believes that members still will be able to communicate with

their customers through a number of channels, and that the proposed rules will enhance rather than compromise investor protection.

SIFMA noted that it is difficult to follow the proposed rules in the form presented in the Proposing Release and urged FINRA to simplify that presentation. FINRA notes that it presents the proposed rule text in the format required by SEC Form 19b-4 under the Exchange Act.

SIFMA also recommended that FINRA completely exclude research reports from proposed FINRA Rule 2210, on the ground that NASD Rule 2711 sufficiently regulates these communications. FINRA disagrees. While NASD Rule 2711 does include certain required disclosures for research reports, it lacks other important content standards, such as the requirement that a communication be based on principles of fair dealing and good faith, and be fair and balanced. In addition, proposed FINRA Rule 2210 includes important supervisory and recordkeeping standards that are not found in NASD Rule 2711. FINRA has altered the application of proposed FINRA Rule 2210's content standards to research reports where appropriate. For example, it would exclude research reports from the disclosure requirements for retail communications that include a securities recommendation.

Transition Period

Fidelity recommended that FINRA allow at least six months after SEC approval of the proposed rule change before these changes become effective. Fidelity also recommended that, if FINRA adopts new requirements for the handling of internal training materials, the compliance date should be at least nine months after SEC approval. The ICI recommended that the compliance date be 10 business days after the second calendar quarter end following SEC approval.

FINRA recognizes that members will need time to alter their internal policies and procedures in response to new requirements imposed by the proposed rule change. As discussed in the Proposing Release, FINRA plans on publishing a Regulatory Notice no later than 90 days following SEC approval of the rule changes. The implementation date will be no later than 365 days following SEC approval. In establishing this schedule, FINRA will consider members' need to adopt and implement policies and procedures necessary to comply with the new rules.

* * * *

FINRA believes that the foregoing, along with the discussion in the Proposing Release, fully responds to the issues raised by the commenters. FINRA emphasizes that the proposed rule change would streamline the current communications with the public rules and simplify the categories of communications with the public. FINRA also has tailored the proposed rule change as narrowly as possible to achieve the intended and necessary regulatory benefit. In this regard, FINRA presented the

proposal to the public and solicited comments prior to submitting the proposed rule change to the Commission.²¹

FINRA reviewed the comments and made appropriate changes. For example, recognizing that it may be burdensome for new firms to file all of their retail communications for a one-year period, FINRA narrowed the scope of this filing requirement to cover only retail communications that essentially meet the current definition of advertisement. In addition, FINRA revised the proposed filing requirements for retail communications concerning collateralized mortgage obligations (“CMOs”) and structured products. As discussed in the Proposing Release, FINRA agreed there may be situations in which a pre-use filing requirement would prevent members from distributing time-sensitive retail communications concerning CMOs and structured products in a timely manner, and revised the proposal to permit members to file such retail communications within 10 business days of first use, instead of at least 10 business days prior to use.

And, as further detailed above, FINRA has proposed additional changes after careful consideration of comments raised in response to the publication of the revised proposal in the Federal Register. In particular, FINRA has amended the proposal to eliminate the proposed filing requirement for retail communications concerning government securities, and streamlined the disclosure requirements for retail communications and public appearances that include a recommendation of securities.

If you have any questions, please contact Philip Shaikun, Associate Vice President and Associate General Counsel, at (202) 728-8451, or me at (240) 386-4534.

Very truly yours,



Joseph P. Savage
Vice President & Counsel
Investment Companies Regulation

²¹ See Regulatory Notice 09-55 (Sept. 2009).