FINRA
Financial Industry Regulatory Authority

Joseph P. Savage
Vice President & Counsel
Investment Companies Regulation

December 22, 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 – Rebuttal

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.

On October 31, 2011, FINRA filed Partial Amendment No. 1 to the proposed rule change and a letter responding to comments.[2] On November 7, 2011, the Commission published in the Federal Register a notice and order to solicit comments on Partial Amendment No. 1 from interested persons and to institute proceedings pursuant to Section 19(b)(2)(B) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether to approve or disapprove the proposed rule change, as modified by

---

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").

2 See letter from Joseph P. Savage, FINRA, to Elizabeth Murphy, Secretary, SEC, dated October 31, 2011; see also Partial Amendment No. 1 to SR-FINRA-2011-035, available on www.finra.org.

1735 K Street, NW
Washington, DC
20006-1506
t 202 728 8000
www.finra.org

Partial Amendment No. 1.[3] The Commission received seven comment letters in response to this notice.[4] This letter responds to those comments and rebuts any assertion that the proposed rule change, as amended, would not meet the statutory requirements for approval.[5]

Internal Communications

Schwab, Fidelity, the ICI, SIFMA and Vanguard all opposed proposed Supplementary Material 2210.01, which states 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 paragraph (a)(3) of this Rule. Accordingly, such internal

---

3 See Securities Exchange Act Release No. 65663 (November 1, 2011), 76 FR 68800 (November 7, 2011) (Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, etc.). The comment period closed on December 7, 2011.

4 See letter from Melissa Callison, Vice President, Compliance, Charles Schwab & Co., Inc., dated December 7, 2011 ("Schwab"); letter from Alexander C. Gavis, Vice President & Associate General Counsel, Fidelity Investments, dated December 7, 2011 ("Fidelity"); letter from David T. Bellaire, General Counsel and Director of Government Affairs, Financial Services Institute, dated December 7, 2011 ("FSI"); letter from Dorothy M. Donohue, Senior Associate Counsel, Investment Company Institute, dated December 7, 2011 ("ICI"); letter from John Polanin and Claire Santaniello, Co-Chairs, Compliance and Regulatory Policy Committee of the Securities Industry and Financial Markets Association ("SIFMA"); letter from Sandra J. Burke, Principal, Vanguard, dated December 7, 2011 ("Vanguard"); and letter from Jeremiah McGair, Attorney, Wolverine Execution Services, LLC, dated December 7, 2011 ("Wolverine").

5 FINRA notes that the Commission requested comment, in particular, on six aspects of the proposed rule change. Commenters did not submit comments on two aspects cited by the Commission: the requirements applicable to communications prepared by research department personnel, and the scope of the proposed exclusion from the content standards as set forth in proposed FINRA Rule 2210(d)(8). The Commission also requested comment, in particular, on the scope of the category of associated persons whose financial interests would have to be disclosed in a retail communication that includes a securities recommendation. The FSI, which was the only commenter that cited this provision, stated that it "would like to applaud FINRA for responding to our requests for greater clarification by providing a narrower and clearer standard of who is required to disclose a financial interest with respect to communications that provide a recommendation of a security."

communications are subject to both the provisions of this Rule and NASD Rule 3010(d) (Review of Correspondence)."

Schwab stated that internal education and training materials are not sales material created for public distribution, and as such, not all of Rule 2210's policy concerns apply to such materials. Schwab agreed that internal materials should be fair, balanced and accurate to support appropriate sales practices by registered representatives, but stated that this goal could be achieved by having such communications subject only to NASD Rule 3010. In particular, Schwab noted that Rule 3010 "provides a sufficient regulatory basis for requiring member firms to develop policies, procedures and supervisory controls to support the development of training materials that are accurate and balanced in describing a firm's products and services."

Fidelity, the ICI and SIFMA argued that a reasonable reading of the definition of "institutional investor" under NASD Rule 2211 might lead to the conclusion that it is intended to include external parties, including third-party broker-dealers and their associated persons, but not the FINRA member firm or its associated persons creating an internal communication. Accordingly, these commenters argued that the term "institutional sales material" under NASD Rule 2211 could be read to exclude internal communications. Fidelity, the ICI, SIFMA and Vanguard also argued that the additional costs that would be imposed on firms by including internal communications within the term "institutional communication" would far exceed any incremental benefits to investors, given the protection investors already receive under NASD Rule 3010.

FINRA does not agree with the commenters that internal communications are not included within the term "institutional sales material" under NASD Rule 2211. The plain language of the definition of "institutional investor" includes any broker-dealer and its associated persons and contains no express carve-out for a firm's internal communications to its associated persons. Moreover, FINRA has previously issued public guidance making clear that the content standards of the rules governing member communications with the public apply to a member's internal communications.[6]

FINRA further notes that a similar comment was raised in response to FINRA's proposed amendments to its communications with the public rules in 2000. In response to a commenter that asserted that a member firm's internal communications are not communications with the public, FINRA responded that while Rule 2210 excepts internal-use only communications from the filing requirements, it had long taken the position that broker-dealer-only materials must meet the rule's content and record-

---

6 See, e.g., NASD Regulatory & Compliance Alert, "Ask the Analyst" (September 1998), available on www.finra.org.

keeping requirements.[7] The Commission noted the comment and response in approving the proposed rule change.[8]

Notwithstanding that plain language and public guidance, FINRA has determined to revise the proposed rule change so that contrary to existing rules, going forward, should the proposed rule change be approved, internal communications would no longer be governed by proposed FINRA Rule 2210, and instead would be governed by NASD Rule 3010 (and any successor FINRA Rule), as well as other applicable rules.

As the commenters acknowledge, NASD Rule 3010 requires firms to supervise internal communications, including internal communications that train or educate registered representatives. Under NASD Rule 3010, firms must establish, maintain and enforce written procedures to supervise the types of business in which they engage and to supervise associated persons' activities that are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA Rules, including the suitability rule and just and equitable principles of trade.[9] FINRA is of the view that with respect to internal communications for training and education, a firm's supervisory scheme would be deficient unless its policies and procedures are reasonably designed to ensure that such communications are fair, balanced and accurate.

FINRA further notes that firms also must determine the extent to which the review of internal communications is necessary in accordance with the supervision of their business[10] and maintain records of all internal communications relating to their business as a broker-dealer.[11]

---

7 See letter from Barbara Z. Sweeney, NASD, to Katherine A. England, Assistant Director, SEC, dated November 4, 2002 (re: File No. SR-NASD-00-12).

8 Securities Exchange Act Release No. 47820 (May 9, 2003), 68 FR 27116 (May 19, 2003) (Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3 and 4 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Concerning Amendments to Rules Governing Member Communications With the Public (File No. SR-NASD-00-12)).

9 See NASD Rule 3010(b)(1).

10 See Regulatory Notice 07-59 (FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications) (December 2007). Regulatory Notice 07-59 further makes clear that a member must have reasonably designed procedures for the supervisory review of those internal communications that are of a subject matter that require review under FINRA rules and the federal securities laws.

11 See Exchange Act Rule 17a-4(a)(4); FINRA Rule 4511(a).

Taken together, FINRA believes these other existing rule requirements effectively lead to the same review and content standards as is set forth in proposed Supplementary Material 2210.01. For these reasons, FINRA has determined not to include internal educational and training materials within the term "institutional communication" for purposes of FINRA Rule 2210, and proposes to delete Supplementary Material 2210.01. FINRA also is amending the definition of "institutional communication" (proposed FINRA Rule 2210(a)(3)) to specifically exclude a member's internal communications.

Definition of "Institutional Investor"

A number of commenters recommended that FINRA revise the definition of "institutional investor" in proposed FINRA Rule 2210(a)(4). The proposed definition would largely remain unchanged from the current definition of "institutional investor" in NASD Rule 2211(a)(3).[12]

The proposed definition would include certain employee benefit plans and qualified plans that have at least 100 participants (but does not include any participants in such plans). Fidelity recommended FINRA eliminate the requirement that such plans have at least 100 participants. Fidelity argued that, because all retirement plan sponsors have fiduciary responsibilities under the Employee Retirement Income Security Act of 1974 ("ERISA"), they are required to have an in-depth understanding of investment concepts and of the products chosen as retirement plan options, or they must use the assistance of others who have such knowledge. Accordingly, Fidelity did not agree that small retirement plans should receive the same investor protections as retail investors.

The proposed definition would include the persons listed within the definition of "institutional account" in FINRA Rule 4512(c). These persons include banks, savings and loan associations, insurance companies, registered investment companies, registered investment advisers, and any other person (not included in the prior categories) with total assets of at least $50 million. Fidelity and Wolverine both urged FINRA to lower this "catch-all" asset threshold to $5 million rather than $50 million. These commenters noted that the SEC uses a $5 million asset threshold to determine what persons fall within the definition of "accredited investor" for purposes of Securities Act Regulation D.[13] Alternatively, they recommended that FINRA adopt the "qualified investor" definition

---

12 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 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.

13 See 17 C.F.R. § 230.501(a).

under the Exchange Act,[14] or the "qualified purchaser" definition under the Investment Company Act of 1940,[15] as a test of investor sophistication in lieu of its proposed definition. They also argued that adopting one of these alternative tests would create greater harmony among various securities laws and regulations.

SIFMA commented that, while it prefers the expanded definition of "institutional investor" under proposed FINRA Rule 2210(a)(4) to the definition of "institutional account" under FINRA Rule 4512(c), it "strongly urges FINRA to adopt one standard or the other." SIFMA noted that firms should not be required to build systems to comply with inconsistent definitions of "institutional investor" and "institutional account," and thus FINRA should have a uniform standard within its consolidated rulebook.

The definition of "institutional investor" also provides 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 commented that this standard creates substantial ambiguity, and urged FINRA to provide more guidance regarding member obligations under this standard. In particular, the FSI inquired whether FINRA expects members to be proactive in obtaining information regarding the ultimate use of communications designed for institutional investors or whether members may satisfy their obligations by relying on assurances provided by financial advisors that such communications have not been forwarded to retail investors.

FINRA does not agree with the comment that it should eliminate its current 100-participant threshold in order for employee benefit plans to be considered institutional investors. As it has stated in past responses to this comment, FINRA believes that smaller plans require greater protection under the rules governing member communications than do larger plans. Plans with at least 100 participants are more likely to have either the sophistication required to scrutinize member sales material without the benefit of the filing and increased content standards applicable to retail communications, or have the resources necessary to hire an outside party with this sophistication. The fact that ERISA requires all plan sponsors to understand the investments they select for their plans does not ensure that they have either investment sophistication or resources.

FINRA established the 100-participant threshold for retirement plans covered by its institutional investor definition when it first adopted this definition in 2003. The ICI recommended this threshold as an appropriate cut-off point for retirement plans, citing the fact that ERISA distinguishes qualified plans with at least 100 participants from smaller plans.[16] At that time FINRA agreed that this standard was a reasonable way to

---

14 See 15 U.S.C. § 78c(a)(54).

15 See 15 U.S.C. § 80a-2(a)(51).

16 See letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Joan Conley, NASD Regulation, Inc., dated October 29, 1999, citing ERISA §§

distinguish between large and small retirement plans.[17] FINRA does not believe commenters have provided any evidence why this standard should be revised today.

FINRA acknowledges that the definition of "institutional investor" differs from the definition of "institutional account" under FINRA Rule 4512(c), as well as from the definitions of other terms such as "accredited investor" or "qualified purchaser" under the federal securities laws. FINRA notes that regardless of which definition FINRA chooses to adopt for the communication with the public rules, inconsistency will remain, as FINRA has no ability to alter definitions contained in either federal statutes or SEC rules.

While FINRA could narrow the definition of "institutional investor" under proposed FINRA Rule 2210(a)(4) to match the definition of "institutional account" under FINRA Rule 4512(c), as suggested by SIFMA, FINRA believes that the current broader definition establishes an appropriate standard for institutional communications and that this change could harm members that are relying on the current definition of "institutional investor" under NASD Rule 2211(a)(3). Accordingly, FINRA declines to revise the definition of "institutional investor" purely for the purpose of making it consistent with Rule 4512. Indeed, FINRA notes that the federal securities laws have varying rules of exempted investors among different parts of the federal regulatory scheme.

FINRA also does not believe it makes sense to lower the asset threshold to $5 million or $25 million. In fact, there would be no more reason to so lower the threshold than to raise it to a higher one, such as the threshold for a "qualified institutional buyer" (certain institutions holding $100 million in securities) under Rule 144A of the Securities Act of 1933.[18] In FINRA's experience, the $50 million asset threshold has served as a reasonable way to distinguish retail and institutional customers. Indeed, commenters did not question the $50 million asset threshold as it was approved by the Commission earlier this year into the definition of "institutional account" in FINRA Rule 4512(c).[19]

103(a)(3)(A) (auditing requirements) and 104(a)(2)(A) (annual reporting), 29 U.S.C. §§ 1023(a)(3)(A), 1024(a)(2)(A).

17 See Securities Exchange Act Release No. 45181, 66 FR 67586 (December 31, 2001) (Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. Concerning Amendments to Rules Governing Member Communications with the Public).

18 See 17 C.F.R. § 230.144A(a)(1).

19 See letter from Afshin Atabaki, Assistant General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (January 13, 2011) (response to comments to proposed rule change to adopt the consolidated FINRA books and records rules, SR-FINRA-2010-052), available on www.finra.org.

There have been numerous criticisms of the accredited investor standard under Regulation D since its creation. Some have criticized the standard on the ground that net worth, income or asset size may not be an indication of an investor's ability to bear the risk of loss.[20] Others have criticized the definition as both under-inclusive, by excluding financially sophisticated investors who do not meet the definition's wealth tests, and over-inclusive, by including wealthy financial novices.[21] The same criticisms can be made, of course, for any other test of investor sophistication that is based upon measures of wealth, such as "qualified investor" or "qualified purchaser."

What has become clear in FINRA's experience in regulating member sales material is the fact that even where investors may meet an "accredited investor" or other standard under the federal securities laws, it does not assure that sales material used with such investors will not be misleading or fraudulent, nor are such investors immune from being deceived by such material. This is particularly true for individual investors that may have enough wealth to qualify for investing in privately placed securities, but lack the knowledge and understanding necessary to prevent investor harm from occurring.

For example, in one case, a member distributed sales literature regarding specific hedge funds to its customers that had inadequate risk disclosures about the specific risks of investing in these hedge funds and made unbalanced presentations that failed to provide investors with a sound basis for evaluating the facts associated with investments in these funds. These materials included projections of performance that were unwarranted.[22]

In another case, a member distributed sales literature regarding privately placed registered investment companies that contained inadequate risk disclosures, and that stated that the fund was seeking a targeted rate of return without providing a substantiated basis for the target.[23] Another case regarding the advertising of hedge fund investments also involved sales presentations and prospecting letters that did not provide a sound basis for investors to evaluate the reasonableness of targeted investment returns. In some cases, the sales material included hypothetical results that were combined with the hedge fund's actual performance, giving the misimpression that the fund had actually achieved the combined performance record.[24]

---

[20] See, e.g., Manning Gilbert Warren III, A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933, 33 Am. U. L. Rev. 355, 382 (1984).

[21] See, e.g., Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 Cal. L. Rev. 279, 310 (2000).

[22] See Altegris Investments Inc., AWC No. CAF030015 (April 15, 2003).

[23] See UBS Financial Services Inc., AWC No. CAF040051 (June 16, 2004).

[24] See Citigroup Global Markets, Inc., AWC No. CAF040077 (Oct. 4, 2004).

In another recently litigated case, a member distributed emails to investors that qualified as accredited investors that contained predictions or projections of performance, including claims of returns of up to 100 percent annually and "comfortable" returns of 25-50 percent. Aside from violating FINRA rules prohibiting such projections of performance, these claims also lacked any historical support, and the emails lacked risk disclosures. An investor who responded to these solicitations in fact lost 23 percent of its investment.[25]

The Commission should bear in mind that, unlike the accredited investor definition, the "institutional investor" definition does not prevent investors from investing in particular funds or products. Rather, it simply requires members to exercise a greater degree of supervision with respect to sales material if it intends to distribute the material to individuals and certain entities that have less than $50 million in assets.

In many cases (and in most cases involving privately placed securities), the designation of a communication as retail rather than institutional simply means that a registered principal must approve the retail communication prior to use. In the cases where the retail communication concerns an investment that triggers a filing requirement, such as a mutual fund or publicly offered direct participation program, the member must file the retail communication with FINRA within 10 business days of first use. There may also be some content standards that apply to retail communications that do not apply to institutional communications. FINRA believes these additional requirements help ensure that investor communications are fair, balanced and accurate.

However, if an investor is represented by certain intermediaries, such as a bank, registered investment adviser or broker-dealer, the member may treat communications intended solely for those intermediaries as institutional communications, even if the investor himself has less than $50 million in assets. And in no case does the designation of a communication as retail somehow prevent investors from accessing the capital markets.

Moreover, Section 415 of the Dodd-Frank Wall Street Reform and Consumer Protection Act instructed the Government Accountability Office ("GAO") to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status to invest in private funds. The GAO study is due to the Senate Banking, Housing and Urban Affairs Committee and the House Financial Services Committee within three years after the date of enactment of the Dodd-

---

25 See Dep't of Enforcement v. Hedge Fund Capital Partners LLC, Complaint No. 2006004122402, 2011 FINRA Discip. LEXIS 20 (Jan. 26, 2011), *appeal docketed*, Feb. 7, 2011.

Frank Act.[26] It would make little sense to adopt a standard that Congress has questioned and that may become obsolete in a few years.

FINRA appreciates the need for guidance regarding the "reason to believe" standard that is employed in the definition of "institutional investor." FINRA does not intend to impose an affirmative obligation on members to inquire whether an institutional communication will be forwarded to retail investors every time such a communication is distributed. Rather, members should have policies and procedures in place reasonably designed to ensure that institutional communications are not forwarded to retail investors, and make appropriate efforts to implement such policies and procedures.

While the use of legends on institutional communications that are intended to limit a communication's distribution can be part of such policies and procedures, the use of legends by themselves is not sufficient. For example, as the FSI suggests, firms may wish to get periodic assurances from institutional investors that they will not forward institutional communications to retail investors. In addition, to the extent a member or associated person becomes aware that an institutional investor is forwarding or making available institutional communications to retail investors, it must treat future communications sent to such institutional investors as retail communications, until it reasonably concludes that the improper practice has ceased.

Public Appearances

Currently NASD Rule 2210 includes a separate communication category "public appearance," which is defined to include "participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity."[27] In its guidance concerning social media websites, FINRA has explained that participation in an interactive electronic forum on a social media website also is considered a "public appearance" for purposes of NASD Rule 2210. Nevertheless, FINRA made clear that firms are expected to keep records of such participation as required by Exchange Act Rules 17a-3 and 17a-4, and that firms must supervise such communications under NASD Rule 3010 in a manner reasonably designed to ensure that they do not violate the content requirements of FINRA's communications rules.[28]

Under proposed FINRA Rule 2210, "public appearances" would no longer be a separate category of the term "communications." Instead proposed FINRA Rule 2210(f) would govern public appearances. In addition, the term "public appearance" would

---

26 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (2010) § 415.

27 See NASD Rule 2210(a)(5).

28 See Regulatory Notice 10-06 (Guidance on Blogs and Social Networking Web Sites) (January 2010).

include participating in a seminar, forum, radio or television interview, and other public appearances or speaking activities that are unscripted and do not constitute retail communications, institutional communications or correspondence.

It would not include participation in an interactive electronic forum, however. Instead, such participation would fall under the term "retail communication," assuming the forum is generally available to the public. Proposed FINRA Rule 2210(b)(1)(D)(ii) would allow members to supervise and review retail communications that are posted on an online interactive electronic forum in the same manner as required for supervising and reviewing correspondence under NASD Rule 3010(d). Thus, members would not have to approve each such retail communication prior to use, and would have flexibility on how they establish their supervisory systems.

Fidelity and SIFMA recommended that FINRA maintain its current definition of "public appearance" under NASD Rule 2210 and include interactive electronic communications within this framework, "recognizing that these communications are more analogous to physical public appearances." Fidelity expressed concern that otherwise, interactive electronic communications may fall into the definitions of correspondence, institutional communications or retail communications, which would complicate how the rules apply to such communications. SIFMA recommended that FINRA exclude content that is interactive rather than static from the filing requirements under proposed FINRA Rule 2210(c), arguing that the burden of filing interactive online postings would far outweigh any potential benefits.

FINRA disagrees that participation in an online interactive forum is more analogous to a physical public appearance than other electronic communications. An online interactive forum post generally remains available to the public for an extended period of time. Unless an interview or other public speaking activity is recorded and made available afterwards through some other medium, it no longer is available to the public after the interview or speech is completed. Accordingly, FINRA believes it is more appropriate to classify online interactive forum posts generally to be retail communications rather than public appearances.

FINRA recognizes that often participation in online electronic forums occurs on a real-time basis and thus does not lend itself easily to pre-use principal approval. Accordingly, FINRA has allowed firms the flexibility to supervise participation in online electronic forums in the same manner as they supervise correspondence, which can include post-use review.[29] FINRA therefore believes the concerns expressed by Fidelity regarding whether an online forum post is correspondence, an institutional communication or a retail communication are overstated: as a general matter, under the rule proposal, the supervisory requirements will be the same regardless.

---

29 See Regulatory Notice 10-06 (Guidance on Blogs and Social Networking Web Sites) (January 2010); see also Regulatory Notice 07-59 (FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications) (December 2007).

FINRA recognizes that a member may face supervisory and operational difficulties if it is required to file an online forum post given that the member will be supervising such communications in the same manner as correspondence. Accordingly, FINRA is amending proposed FINRA Rule 2210(c)(7) to add a filing exclusion for retail communications that are posted on online interactive electronic forums. Nevertheless, members should be aware that this exemption does not apply to any filing requirement that may arise under either federal law or SEC Rules.[30]

Shareholder Reports

FINRA currently requires members to file the Management's Discussion of Fund Performance ("MDFP") and any other sales material included in a mutual fund annual or semi-annual report if a member intends to use the report as sales material with prospective investors. The ICI commented that FINRA should exempt the MDFP from filing with FINRA on the ground that it is already filed with the SEC and subject to certain control and certification requirements under federal law and SEC rules. The ICI also noted that Section 408(c) of the Sarbanes-Oxley Act requires the SEC staff to review issuers' disclosures, including the MDFP, at least once every three years.

While FINRA recognizes that the MDFP is filed with the SEC, as the ICI acknowledges, the SEC staff does not routinely review many MDFPs since they are on a three-year review cycle. In contrast, FINRA reviews all MDFPs that are filed with the FINRA Advertising Regulation Department. FINRA also reviews other non-required content included in shareholder reports that may be intended to promote sales of the fund rather than report on the fund's previous year or six months.

In addition, FINRA review of the MDFP does not impose a large burden on members relative to the benefit to investors by ensuring that the MDFP is fair, balanced and accurate. Members are not required to file any other part of a fund shareholder report, such as the financial statements or accounting notes. Moreover, this review serves a prophylactic purpose of discouraging funds from including content that is misleading or potentially harmful to investors.

Accordingly, FINRA does not agree to exempt a fund shareholder report's MDFP from proposed FINRA Rule 2210's filing requirements to the extent it is used with prospective investors.

Templates

Proposed FINRA Rule 2210(c)(7)(B) would exclude from the filing requirements retail communications that are based on templates that were previously filed with FINRA the changes to which are limited to updates of more recent statistical or other non-

---

30 See, e.g., 15 U.S.C. § 80a-24(b); 17 C.F.R. § 230.497.

narrative information. This filing exclusion would codify a current interpretive position under NASD Rule 2210.[31]

Fidelity and the ICI recommended that FINRA expand this filing exclusion to cover updates of narrative information used in previously filed templates, provided that such narrative information is sourced from an independent data supplier or (with respect to Fidelity) from publicly available documents filed with the SEC. The ICI argues this filing exclusion will save members money, while still allowing FINRA to review updated templates through other means, such as spot-checks or examinations.

FINRA disagrees with this recommendation. Often third-party data providers receive their information about a fund from an affiliate of the fund. Thus, in many cases, this information ultimately will be generated by either the member firm or one of its affiliates. Such information would not be considered from an independent source. In addition, review of narrative updates ensures that members' retail communications are fair, balanced and accurate. This goal is best ensured through filing of updated material.

Closed-End Fund Communications

The ICI noted that many closed-end funds are listed on the New York Stock Exchange ("NYSE"). Section 202.06 of the NYSE Listed Company Manual encourages listed issuers to disseminate "quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities." The ICI commented that, in the case of listed closed-end funds, this information would include, among other things, dividend announcements, and typically is disseminated through press releases. The ICI has asked that FINRA clarify that closed-end funds' press releases issued pursuant to Section 202.06 of the NYSE Listed Company Manual are excluded from the pre-use principal approval and filing requirements.

SIFMA argued that FINRA should exclude from the filing requirements all retail communications concerning closed-end funds. SIFMA argued that such communications pose lower risks than communications concerning other products (such as structured products), and that having a principal review such retail communications prior to use provides sufficient investor protection.

Proposed FINRA Rule 2210(b)(1)(D)(iii) would exclude from the Rule's principal pre-use approval requirements any retail communication that does not make any financial or investment recommendation or otherwise promote a product or service of the member. Likewise, proposed FINRA Rule 2210(c)(7)(C) would exclude such retail communications from the Rule's filing requirements.

---

31 See Letter from Thomas M. Selman, NASD, to Forrest R. Foss, T. Rowe Price Associates, Inc. (January 28, 2002), available on www.finra.org.

To the extent a member distributes or makes available a press release about a closed-end fund that does not make any financial or investment recommendation or otherwise promote a product or service of the member, the member would not be required to have a principal approve it prior to use. FINRA is also amending proposed Rule 2210(c)(7) to add a separate exclusion from the filing requirements for press releases concerning closed-end investment companies listed on the NYSE that are issued pursuant to Section 202.06 of the NYSE Listed Company Manual (or any successor provision).

FINRA does not believe it should exclude other types of retail communications concerning closed-end funds from filing, however. The fact that a principal must approve such communications prior to use is unpersuasive. The same requirement applies to other types of retail communications that are subject to a filing requirement. In addition, FINRA staff has found through filings and investigations of closed-end fund communications under the current rules that such communications frequently require changes in order to be consistent with applicable advertising rules. For example, FINRA staff found significant problems with retail communications used to promote auction-rate securities issued by closed-end funds.

Accordingly, FINRA does not believe it should exclude retail communications concerning closed-end funds from the filing requirements, other than press releases issued pursuant to the NYSE listing standard cited above.

Free-Writing Prospectuses

Proposed FINRA Rule 2210(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 prospectus published pursuant to 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) are not covered by this filing exclusion. Thus, free writing prospectuses that are prepared by or on behalf of a broker-dealer that are also subject to a filing requirement would be required to be filed with FINRA.[32]

SIFMA argues that FINRA should also exclude broker-prepared free writing prospectuses from the filing requirements on the grounds that the SEC staff already reviews such prospectuses under its filing program. SIFMA also argues that such free writing prospectuses may be withheld from publication due to the pre-use filing

---

32 In contrast, free writing prospectuses prepared by or on behalf of the issuer of securities would not have to be filed with FINRA. <u>See</u> 17 C.F.R. §§ 230.433(d)(1)(i) and 230.433(h)(1).

requirements of proposed FINRA Rule 2210(c)(2), which would be contrary to the SEC's goal of timely release of information.[33]

FINRA believes that SIFMA is largely incorrect on both grounds. First, while it is true that broker-prepared free writing prospectuses must be filed with the SEC Division of Corporation Finance under Securities Act Rule 433, this filing does not necessarily ensure Division staff review of all such prospectuses. Accordingly, FINRA believes that its review will add a layer of investor protection that is appropriate under the circumstances. FINRA has also discussed this proposed filing requirement with the staff of the Division of Corporation Finance, which has not objected to this proposed requirement.

Second, the concern that proposed FINRA Rule 2210(c)(2)'s pre-use filing requirements would inhibit the timing of free writing prospectuses fails for its premise. These pre-use filing requirements apply to (A) retail communications concerning registered investment companies that include self-created rankings; (B) retail communications concerning security futures (subject to certain exceptions); and (C) retail communications concerning bond mutual funds that include or incorporate bond mutual fund volatility ratings. Investment companies are not permitted to issue free writing prospectuses. Security futures generally are exempted securities under the Securities Act.[34] As such, there is no need for an issuer or broker-dealer to use free writing prospectus to advertise security futures. Accordingly, the pre-use filing requirements for retail communications concerning investment companies or security futures would not require a free writing prospectus to be filed with FINRA.

Third, the filing requirement only applies to widely disseminated free writing prospectuses that are prepared by or on behalf of a broker-dealer. It would not apply to free writing prospectuses that are not widely disseminated, nor would it apply to widely disseminated free writing prospectuses that are prepared by or on behalf of an issuer.

Similar to existing rules, FINRA also has proposed to impose a pre-use filing requirement for certain types of retail communications distributed by a new member during a one-year period beginning on the date that the member's FINRA membership became effective.[35] SIFMA did not cite this proposed filing requirement as a barrier to using free writing prospectuses in a timely manner. Nevertheless, FINRA is proposing to amend this provision to allow new members to file widely disseminated free writing

---

33 SIFMA cited proposed FINRA Rule 2210(d)(2) in its comment letter; FINRA presumes this citation was a typographical error, since paragraph (d)(2) does not impose a filing requirement.

34 See 15 U.S.C. § 77c(a)(14).

35 See proposed FINRA Rule 2210(c)(1)(A).

prospectuses prepared by or on behalf of a broker-dealer within 10 business days of first use, rather than impose a pre-use filing requirement on such communications.

Transition Period

Fidelity urges FINRA to adopt an implementation date no earlier than at least six months following SEC approval in order to allow members to revise their internal compliance systems to adapt to the new requirements. Fidelity also recommended that if FINRA subjects internal training and education materials to proposed Rule 2210, FINRA should permit a compliance time period of nine months after SEC approval. The FSI requested that FINRA provide, at a minimum, 12 months for members to adapt to the changes.

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 and in its prior response to comments, 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 its response to comments on 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 – changes strongly supported by most commenters. 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,[36] and the public has had two additional opportunities to comment on the proposed rule change since it was filed with the Commission.

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 proposed to delete its proposed Supplementary Material that would have included internal training and education materials about a member's products and services within the definition of institutional communication, and to amend the definition to expressly exclude internal communications. FINRA is proposing to amend the new member filing requirements to eliminate a pre-use filing requirement for widely disseminated, broker-prepared free writing prospectuses. FINRA also has proposed to exclude from the filing requirements

---

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

closed-end fund press releases published pursuant to NYSE listing standards. In addition, FINRA has proposed to exclude from the filing requirements retail communications that are posted on online interactive electronic forums. FINRA also agrees that members should have ample time to adjust their internal policies and procedures before any new rules go into effect.

As a final note, FINRA fully believes the proposed rule change, taken as a whole, fully complies with Exchange Act Section 15A(b)(6), which requires, among other things, that FINRA's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The rules largely replicate current NASD rules that have been in place for many years and been proven effective. Through this system of regulation, firms have understood that their communications may not be written in a manner that could deceive or mislead investors concerning the products and services they offer.

The rules governing review and approval of communications strike an appropriate balance between the need for firms to supervise their communications, while allowing a more flexible supervisory system when the risk to investors is lessened. Thus, members are permitted to employ a more flexible supervisory structure where a communication reaches fewer parties, as in the case of correspondence; where the communication reaches a more sophisticated audience, as in the case of institutional communications; and where the communication does not promote the product or service of the member.

The filing requirements, which have been a critical aspect of FINRA's surveillance program for many years, ensure that communications intended to reach a retail audience concerning some of the most common products for the average investor, such as mutual funds and variable insurance products, or which raise heightened risks for retail investors, such as security futures or structured products, are reviewed by FINRA staff. The knowledge of FINRA's review further acts as a deterrent to false or misleading communications about these products. Finally, the content standards employ a mix of both principles-based standards and specific standards to ensure that communications present a fair, balanced and accurate picture of the products or services being promoted.

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

Joseph P. Savage
Vice President & Counsel
Investment Companies Regulation