

# Regulatory Notice

## 17-06

## Communications with the Public

### FINRA Requests Comment on Proposed Amendments to Rules Governing Communications with the Public

Comment Period Expires: March 27, 2017

#### Executive Summary

As part of FINRA's retrospective review of its rules governing communications with the public, FINRA is soliciting comment on proposed amendments to FINRA Rule 2210 (Communications with the Public). The proposed amendments would create an exception to the rule's prohibition on projecting performance to permit a firm to distribute a customized hypothetical investment planning illustration that includes the projected performance of an asset allocation or other investment strategy, but not an individual security, subject to specified conditions.

The proposed rule text is attached as Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623 or by email at [joseph.price@finra.org](mailto:joseph.price@finra.org);
- ▶ Thomas A. Pappas, Vice President, Advertising Regulation, at (240) 386-4553 or by email at [tom.pappas@finra.org](mailto:tom.pappas@finra.org); or
- ▶ Joseph P. Savage, Vice President and Counsel, Regulatory Policy, at (240) 386-4534 or by email at [joe.savage@finra.org](mailto:joe.savage@finra.org).

#### February 2017

##### Notice Type

- ▶ Request for Comment

##### Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management

##### Key Topics

- ▶ Communications with the Public
- ▶ Supervision

##### Referenced Rules & Notices

- ▶ FINRA Rule 2210
- ▶ FINRA Rule 2241
- ▶ FINRA Rule 3110

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 27, 2017.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

**Important Notes:** All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>2</sup>

## Background and Discussion

### Rule 2210

Rule 2210 provides that communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast.<sup>3</sup> The general prohibition against performance projections is largely intended to protect retail investors from performance projections of individual investments, which often prove to be spurious, inaccurate or otherwise misleading.

On the other hand, information regarding the expected performance of an asset allocation or other investment strategy that does not project the performance of individual securities could better inform an investor about assumptions upon which the recommendation to pursue such a strategy is based. Commenters to FINRA's retrospective review of the communications rules suggested that investors would benefit from projections in that more limited context and noted that investment advisers often present performance

projections in their communications with their clients, particularly in communications concerning financial planning or asset allocation. The Investment Advisers Act does not prohibit the presentation of projections that comply with the antifraud provisions of the Act.

### Proposed Amendments

The proposal would provide an exception to the prohibition of projections for a customized hypothetical investment planning illustration.<sup>4</sup> The exception would be available for all firms, including firms that operate only an online platform, and could be used with both current and prospective customers. The illustration may project an asset allocation or other investment strategy, but not the performance of an individual security.<sup>5</sup> The proposal would require that there be a reasonable basis for all assumptions, conclusions and recommendations, and that the illustration clearly and prominently disclose the fact that the illustration is hypothetical and there is no assurance that any described investment performance or event will occur. All material assumptions and limitations applicable to the illustration would have to be disclosed.

The “reasonable basis” requirement follows well-established precedents. FINRA Rules 2210 and 2241 (Research Analysts and Research Reports) require a price target in a research report to have a reasonable basis.<sup>6</sup> SEC rules also require performance projections contained in offering documents or prospectuses to be based on good faith and have a reasonable basis.<sup>7</sup>

A “reasonable basis” might be established, for example, by reference to the historical performance and performance volatility of asset classes, the duration of fixed income investments, the effects of macroeconomic factors such as inflation and changes in currency valuation, the impact of fees, costs and taxes, and expected contribution and withdrawal rates by the customer. An unreasonable emphasis on any one of these factors might cause the projection to be noncompliant. Moreover, basing a projection upon hypothetical back-tested performance (which FINRA has interpreted the communications rules to prohibit in retail communications) or the past performance of particular investments by an asset manager would not be reasonable.<sup>8</sup>

The proposal also would establish specific supervisory requirements for the permitted illustrations. A firm could use a template, such as one provided by a reliable off-the shelf software package, to generate the permitted illustration. In that case a registered principal would be required to approve the template before use or distribution, and the illustrations would have to be reviewed in a manner similar to correspondence under FINRA Rule 3110 (Supervision). A firm that does not employ a template would be required to have a registered principal review and approve each illustration before use or distribution.

### **Economic Impact Assessment**

The amendments in this rule proposal are intended to better harmonize regulatory standards and allow firms to communicate, subject to limitations, information regarding the expected performance of an asset allocation or other investment strategy.

FINRA anticipates that most firms that currently file communications associated with investment analysis tools would communicate projections for a customized hypothetical investment planning illustration that are consistent with the proposed amendments. FINRA estimates that there were 20 such firms in 2016. In addition to these firms, the staff believes that many firms providing products and services to retail investors would likely also choose to rely on the proposed exception for projections. FINRA estimates that there are approximately 1,900 such firms that are retail-oriented.<sup>9</sup>

FINRA notes that some of the retail-oriented firms may have clients that are already receiving projections-related communications as part of their investment advisory client accounts. For example, some of the retail-oriented firms are dually-registered and have dually-registered representatives that may be already communicating information regarding expected performance or projections to their investment advisory clients.<sup>10</sup> Similarly, firms that are not dually registered may still have registered representatives that are dually registered and provide clients investment advisory services that may include performance projections. These dually-registered firms or representatives may choose to align the way they provide projections in their investment advisory business to the proposed amendments, thereby simplifying compliance and minimizing the costs of regulatory oversight.

### **Anticipated Benefits**

The proposed amendments would allow firms to communicate information as described above regarding the expected performance of an asset allocation or other investment strategy. Such communication could better inform investors about the recommended investment strategies, including the underlying assumptions upon which the recommendations are based. FINRA anticipates that these benefits would largely accrue to clients that do not have investment advisory accounts, and as a result, are not already receiving projections-related communications. Firms that are not dually registered or that do not employ dually-registered persons may be able to compete more effectively, as they now can provide a potentially valuable service to their clients.

### **Anticipated Costs**

Firms that would rely on the exception in the proposal to communicate permitted illustrations would be required to follow supervisory requirements, including review and approval from a registered principal. As a result, these firms would incur costs associated with principal review, including the staff and technology resources needed to conduct the required reviews.

The proposed amendments would allow firms to use a template to generate the permitted illustrations, in which case the registered principal would be required to approve the template. Alternatively, a firm may choose not to use a template, in which case the principal would be required to review each illustration before use or distribution. Firms would have flexibility in determining whether or not to use a template, which is intended to allow firms to choose the most cost effective option based on their business. Moreover, firms would not be required to file these communications with FINRA for review, and as a result, would not incur any costs associated with filing, such as filing fees.

Firms likely also would incur costs associated with updating their policies and procedures. These costs would include training their registered representatives that use projections with customers and advertising review staff.

The proposal permits firms to communicate projections under the described conditions, but does not require them to do so. As such, firms may choose not to incur the costs associated with the proposal.

## Request for Comment

FINRA requests comment on all aspects of the proposed amendment, including the appropriate scope of these amendments and potential impacts on firms, associated persons and the public. FINRA requests that commenters provide empirical data or other factual support for their comments whenever possible. FINRA specifically request comments concerning the following issues:

1. In addition to the economic impacts identified in this proposal, are there other significant sources of impacts, including direct or indirect costs and benefits, of the proposed amendments to the firms and investors? What are these economic impacts and what factors contribute to them? What would be the magnitude of these costs and benefits? Please provide data or other supporting evidence.
2. To what extent do dually-registered firms have customers that do not have investment advisory accounts and as a result are not able to receive projections- related communications consistent with the Advisers Act? To what extent do these firms anticipate using the proposed exception in this proposal for these customers, or other customers? What would be the primary sources of benefits and costs for these firms and their customers?
3. To what extent will dually-registered firms or representatives align the performance projections in their investment advisory services to the proposed amendments? What aspects of those projections, if any, would not be aligned?
4. Are there other alternative approaches FINRA should consider to accomplish the goals described in this proposal? If so, what are those alternatives and why are they better suited?

5. This *Regulatory Notice* includes examples of factors that would and would not provide a “reasonable basis” for performance projections under the proposal. Are the historical performance and performance volatility of asset classes appropriate factors that would provide a reasonable basis for performance projections? Are there other examples that FINRA should provide that would further clarify what would constitute a “reasonable” basis for a performance projection?
6. The proposal would not permit performance projections for a single security. Securities Act Rule 156, which governs investment company sales literature, provides in part that a statement could be misleading because it includes representations about future investment performance.<sup>11</sup> Are there single investment products that operate like an asset allocation or other investment strategy for which performance projections might be appropriate?
7. The proposal would permit a single projection in a customized hypothetical investment planning illustration. Requiring a range for projections, however, could make the hypothetical nature of a performance projection more apparent. Should the proposal require a range of projections?

## Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Person should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. There are four exceptions from the prohibition on projections: hypothetical illustrations of mathematical principles, investment analysis tools, price targets in research reports, and certain projections concerning security futures and options.
4. A “customized” investment planning illustration is one designed for a particular client or multiple clients who share an account.
5. The proposal would not limit a firm’s ability to provide estimated annual income and estimated yield in customer account statements for individual securities that produce income consistent with the guidance in *Regulatory Notice 08-77*.

6. See FINRA Rule 2210(d)(1)(F)(iii) and FINRA Rule 2241(c)(1)(B).
7. See Securities Act Regulation S-K, 17 CFR § 229.10(b).
8. Hypothetical back-tested performance attempts to show how a portfolio or index constructed with the benefit of hindsight would have performed during a certain period in the past if the product or index had been in existence during such time. Back-tested performance differs from historical performance in that historical performance measures how a portfolio or index actually performs after the investment allocation decisions have been made, without the benefit of hindsight.
9. FINRA's estimate is based on member responses to the 2016 Risk Control Assessment (RCA) survey. The RCA survey includes a question on the types of customers that the responding member firm serves. Approximately 2,250 members responded to the RCA survey in 2016. FINRA believes that the responding firms are representative of the overall membership. Based on the RCA responses, FINRA estimates that approximately 48 percent of all members (about 1,900 members) have retail clients, including high net-worth clients.
10. FINRA estimates that approximately 620 of the firms (or 16 percent of the overall membership) are dually registered as both broker-dealers and investment advisers. FINRA further estimates that these dually-registered firms have approximately 408,100 registered representatives, accounting for 63 percent of total registered representatives. These representatives may be registered solely as broker-dealer representatives or dually registered as both investment adviser and broker-dealer representatives. FINRA notes that some of the dually-registered firms may also have other representatives that are solely registered as investment adviser representatives.
11. See 17 CFR § 230.156(b)(2).

## Attachment A

Proposed Changes to Rule 2210 to Allow Projections in Investment Planning Presentations  
(New text is underlined)

### 2210. Communications with the Public

#### (a) Definitions

No change.

#### (b) Approval, Review and Recordkeeping

(1) – (3)

No change.

#### **(4) Customized Hypothetical Investment Planning Illustrations**

A member shall supervise illustrations permitted under paragraph (d)(1)(F)(iv) (“investment planning illustrations”) by requiring a registered principal either to:

(A) review and approve each investment planning illustration before use or distribution; or

(B) review and approve each template for investment planning illustrations before use or distribution, and supervise and review the investment planning illustrations in the same manner as required for supervising and reviewing correspondence under Rule 3110.

#### **[(4)] (5) Recordkeeping**

(A) Members must maintain all retail communications and institutional communications for the retention period required by SEA Rule 17a-4(b) and in a format and media that comply with SEA Rule 17a-4. The records must include:

(i) a copy of the communication and the dates of first and (if applicable) last use of such communication;

(ii) the name of any registered principal who approved the communication and the date that approval was given;

(iii) in the case of a retail communication or an institutional communication that is not approved prior to first use by a registered principal, the name of the person who prepared or distributed the communication;



(iv) information concerning the source of any statistical table, chart, graph or other illustration used in the communication; and

(v) for any retail communication for which principal approval is not required pursuant to paragraph (b)(1)(C), the name of the member that filed the retail communication with the Department, and a copy of the corresponding review letter from the Department.

(B) Members must maintain all correspondence in accordance with the record-keeping requirements of Rules 3110.09 and 4511.

**(c) Filing Requirements and Review Procedures**

No change.

**(d) Content Standards**

**(1) General Standards**

(A)–(E)

No change.

(F) Communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast; provided, however, that this paragraph (d)(1)(F) does 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 an investment analysis tool, that meets the requirements of Rule 2214; [and]

(iii) A price target contained in a research report on debt or equity securities, provided that the price target has a reasonable basis, the report discloses the valuation methods used to determine the price target, and the price target is accompanied by disclosure concerning the risks that may impede achievement of the price target; and

(iv) A customized hypothetical investment planning illustration that projects performance of an asset allocation or other investment strategy and not an individual security, provided that:

- a. there is a reasonable basis for all assumptions, conclusions and recommendations; and
- b. the illustration clearly and prominently discloses:
  - (I) that the illustration is hypothetical;
  - (II) that there is no assurance that any described investment performance or event will occur; and
  - (III) all material assumptions and limitations applicable to the illustration.

**(2) – (8)**

No change.

**(e) – (g)**

No change.