

Stay on Target: FINRA Proposes Rules Permitting Presentation of Performance Projections and Targets

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The regulation of broker-dealer communications is delegated to the Financial Industry Regulatory Authority, Inc. (FINRA), while investment adviser advertisements are regulated directly by the US Securities and Exchange Commission (SEC). FINRA and the SEC have historically taken very different approaches to the use of performance projections and performance targets. FINRA rules specifically prohibit the use of projections (subject to certain narrow exceptions), while the SEC generally allowed such metrics, historically subject to general anti-fraud requirements and since the adoption of the recently revamped investment adviser marketing rule, Rule 206(4)-1 (SEC Marketing Rule), pursuant to specific requirements regarding the use of “hypothetical performance.”

On 13 November 2023, FINRA proposed **amendments to Rule 2210** (governing communications with the public) that would narrow the differences between the two regulatory frameworks related to use of projections. Specifically, FINRA filed proposed amendments to Rule 2210 (the Proposed Amendments) that borrow heavily from the approach adopted by the SEC in the SEC Marketing Rule and which would permit FINRA members to include performance projections and return targets in their communications, subject to certain limitations and conditions.

SUMMARY

If adopted, the Proposed Amendments would allow FINRA member firms to project the performance or provide a targeted return with respect to a security or asset allocation or other investment strategy in a communication to “institutional investors” or in a communication distributed solely to qualified purchasers (QPs) that promotes or recommends specified nonpublic offerings.

This permission would be subject to three primary conditions:

- The FINRA member adopts policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment

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- objectives of the investor receiving the communication;
 - The FINRA member has a reasonable basis for the criteria and assumptions used in calculating the projections or targets; and
 - The communication includes certain disclosures and information regarding the criteria and assumptions used for—and the risks and limitations of—the performance projections and targets.

FINRA also notes that while the Proposed Amendments have several key differences from the SEC Marketing Rule, FINRA would expect to interpret the Proposed Amendments consistent with the SEC's interpretations of the SEC Marketing Rule.

SCOPE

As an initial matter, the Proposed Amendments would permit the use of projections and targets only with a limited audience of investors: “institutional investors” (as defined in FINRA Rule 2210(a)(4)) and QPs. Communications with institutional investors could include performance projections and targets for any securities, including individual securities, private funds, mutual funds, and exchange traded funds (ETFs). On the other hand, the Proposed Amendments would only permit performance projections and targets in communications to QPs that relate to private placements sold only to QPs (e.g., private funds). This limitation is

different from the SEC Marketing Rule, which requires consideration of the audience's sophistication but does not impose a specified minimum level of sophistication.

Another key distinction between the Proposed Amendments and the SEC Marketing Rule is that the Proposed Amendments would be limited to projections and targets, while the SEC Marketing Rule covers hypothetical performance more broadly, including “backtested performance.” Backtested performance, as discussed in more detail below, is excluded from the scope of the Proposed Amendments.

POLICY AND PROCEDURES

The Proposed Amendments would require policies and procedures be “reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication and to ensure compliance with all applicable requirements and obligations.” These policies and procedures requirements in the Proposed Amendments largely align with the SEC Marketing Rule.

The policies and procedures required by the Proposed Amendments would relate to the “investor receiving the communication” rather than, as in the SEC Marketing Rule,

the “intended audience,” although it is not immediately clear the significance of this change. In adopting the SEC Marketing Rule, the SEC included the phrase “intended audience” in a change from its original proposal to clarify that advisers can group investors into categories or types rather than evaluating each investor individually. Even though the Proposed Amendments do not include the same term (i.e., “intended audience”), FINRA explains in its proposal that FINRA members can rely on past experience with particular types of institutional investors or QPs. That said, the fact that the Proposed Amendments do not use the broader language raises the question of whether FINRA members would need to evaluate the financial situations and investment objectives of the particular recipients of any communication containing projections or performance targets.

REASONABLE BASIS FOR PROJECTIONS / TARGETS

In its most significant deviation from the SEC Marketing Rule, the Proposed Amendments include a specific requirement that the FINRA member using performance projections or targets have—and document—a reasonable basis for the criteria and assumptions used in connection with the projections or targets. The intent of this requirement

is to ensure projections are not “wildly optimistic” and are made in good faith. FINRA notes that the reasonable basis requirement follows existing precedent set forth in FINRA Rules 2210 and 2241 (requiring price targets in a research report to have a reasonable basis) and in SEC Regulation S-K (requiring management projections to have a reasonable basis). FINRA also proposed new Supplementary Material to Rule 2210 that would provide a list of some, but not all, of the factors FINRA members should consider in forming their reasonable basis. This Supplementary Material also clarifies that backtested performance cannot serve as the “reasonable basis” for projected performance or performance targets.

Although the SEC Marketing Rule lacks a specifically analogous requirement, the SEC Marketing Rule includes other requirements that effectively reach the same result (with the exception of the exclusion of backtested performance as a basis for performance targets or projections). Specifically, the SEC Marketing Rule requires advertisements to be fair and balanced and not misleading and requires advisers to be able to substantiate any statements of material fact, including performance targets.

DISCLOSURES

Finally, the Proposed Amendments would require FINRA

members to make certain disclosures when delivering performance projections and targets. First, the communication would be required to prominently disclose that the projections or targets are hypothetical in nature and that there is no guarantee that the projections or targets would be met. In addition and similar to the SEC Marketing Rule, the Proposed Amendments would require FINRA members to disclose the criteria and assumptions and risks and limitations associated with the projections or targets. As with the SEC Marketing Rule, FINRA members would not be required to disclose the specific formulas used or other proprietary information and would be permitted to provide general descriptions so long as such descriptions are sufficient to allow the recipient to understand the risks and limitations and reasons why actual performance may not match the projections or targets.

IMPLICATIONS FOR FINRA MEMBERS

The Proposed Amendments are a welcome step in harmonizing the regulatory requirements applicable to broker-dealers and investment advisers with respect to use of performance advertising. If approved by the SEC, FINRA members would be able to use performance projections and targets in a manner similar to investment advisers, which

should allow for more consistency in the promotion of private funds. The proposed rule would also go a step further for FINRA members communicating with institutional investors, allowing the FINRA member to provide projections or targets relating to single securities (including mutual funds and ETFs).

Another potential implication relates to how the Proposed Amendments would relate to existing FINRA guidance. Specifically, FINRA has noted that unrealized holdings have no actual performance experience and therefore the presentation of related return metrics would constitute a prohibited projection under FINRA Rule 2210. Given that the Proposed Amendments would permit performance projections, it would seem that unrealized holding performance would be permitted, subject to the limitations and conditions of the proposed rule.

Similarly, this proposal could have implications for FINRA member firms who seek to present internal rate of return (IRR) metrics for private funds. FINRA has previously expressed its concerns that the use of IRR for incomplete investment programs in retail communications could be a prohibited forecast or projection; however, FINRA also noted that, for firms with ongoing operations, IRR calculated in accordance with the Global Investment Performance Standards would be permitted. The Proposed Amendments

could allow FINRA member firms additional latitude in presenting IRR metrics to institutional investors or QPs calculated in different methodologies, so long as the FINRA members comply with its conditions.

WHAT'S NEXT?

The Proposed Amendments will be reviewed by the SEC. The SEC may request that FINRA make amendments to its proposal or may publish the proposed rule for public comment. The comment period would last 21 days following the publication of the proposed rule in the Federal Register. After the comment period, the SEC and FINRA would consider comments and, ultimately, issue a final set of amendments.

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