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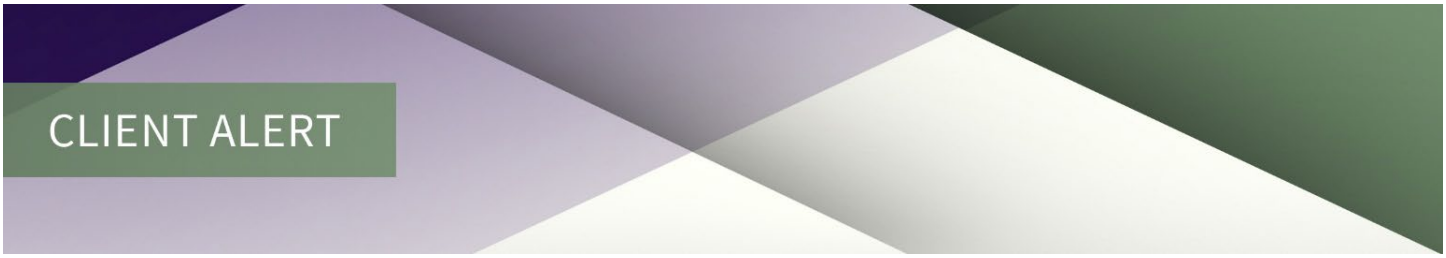

FINRA Proposes to Allow Broker-Dealers to Provide Performance Projections and Targeted Returns to Institutional Investors and QPs for Certain Private Offerings

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On November 13, 2023, FINRA filed a proposed rule change to amend FINRA Rule 2210 (Communications with the Public) (the "Proposal").[1] If approved by the SEC, amended FINRA Rule 2210 would, subject to certain conditions, allow member firms ("Members") to provide projected performance and targeted returns in institutional communications[2] and in communications distributed solely to qualified purchasers ("QPs") as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 ("Investment Company Act")[3] that promote or recommend certain non-public offerings.

1 Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 2210 (Communications with the Public) to Permit Projections of Performance of Investment Strategies or Single Securities in Institutional Communications, Exchange Act Release No. 98977 (Nov. 17, 2023), 88 Fed. Reg. 82482 (Nov. 24, 2023) [SR-FINRA-2023-2016] ("Proposed Rule Change").

2 FINRA Rule 2210(a)(3) defines an "institutional communication" as any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a Member's internal communications. "Institutional investor" is defined in FINRA Rule 2210(a)(4).

3 Section 2(a)(51)(A) defines "qualified purchaser" to mean (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission; (ii) any company that owns not less than $5,000,000 in investments and that is owned

The Proposal addresses comments submitted in response to FINRA's retrospective review of rules governing communications with the public[4] expressing concern that, among other things, FINRA Rule 2210's "prohibition on projections of performance imposes undue restrictions on the broker-dealer customers and in particular institutional investors and QP private placement investors, without providing them a concomitant benefit."[5] The Proposal reflects FINRA's view that there is "no additional risk" in allowing full-service broker-dealers to provide projected performance and targeted returns to customers that might already have access to that information through other intermediaries, including investment advisers and capital acquisition brokers ("CABs"). Notably, the Proposal does not amend FINRA Rule 2210 with respect to the use of related performance or hypothetical back-tested performance in communications distributed to institutional investors or QPs. Comments on the Proposal are due on or before December 15, 2023.

Rule 2210's Prohibition on Projections; Exceptions

Rule 2210 provides, in part, that communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. Subject to specified conditions, the general prohibition currently includes exceptions for performance-related disclosures and tools as follows: (a) a hypothetical illustration of mathematical principles that does not predict or project the performance of an investment or investment strategy; (b) the use of investment analysis tools that include projected performance, where the tool meets the requirements of FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools); (c) price targets on research reports on debt or equity securities;[6] or (d) communications with the public containing projected performance figures for security futures or options (including projected annualized rates of return).[7] The Proposal would not impact any of these exceptions to the general prohibition.

Proposed Amendments to Rule 2210

The Proposal would permit the use of performance projections in (i) institutional communications (i.e., any written, including electronic, communication that is distributed or made available only to institutional investors (as defined in Rule 2210), but not a Member's internal communications); and (ii) communications distributed or made available only to QPs and that promote or recommend either a private offering that is exempt from the requirements of FINRA Rule 5122 pursuant to Rule 5122(c)(1)(B) or a private placement that is exempt from the requirements of Rule 5123 pursuant to Rule 5123(b)(1)(B). As a practical

directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

4 Regulatory Notice 17-06 (Feb. 2017); Regulatory Notice 14-14 (Apr. 2014).

5 Proposed Rule Change, 88 Fed. Reg. at 82489.

6 FINRA Rule 2210(d)(1)(F).

7 FINRA Rule 2215 (Communications with the Public Regarding Security Futures); FINRA Rule 2220 (Options Communications).

matter, for a Member to rely on the Proposal for communications to QPs, the private fund being marketed would need to rely on the exception from the definition of "investment company" in Section 3(c)(7) of the Investment Company Act. The Proposal would not, on its face, apply to other types of private funds, even if a Member limited its distribution solely to QPs.

The exception from the use of performance projections would require members to have: (1) policies and procedures; (2) a reasonable basis for the criteria and assumptions underlying the projected performance; and (3) disclosures to investors that meet the requirements of the Proposal.

Policies and Procedures. The Member would be required to adopt and implement written policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication, and to ensure compliance with all applicable requirements and obligations. This requirement corresponds to Rule 206(4)-1(d)(6)(i) under the Investment Advisers Act of 1940 (the "Marketing Rule"), which imposes its own policies and procedures requirement for private fund and investment adviser marketing materials that contain targeted or projected performance returns. FINRA stated that, in implementing policies and procedures, Members should consider the audience that receives a communication that presents projected performance or a targeted return. In particular, FINRA believes that such a communication should only be distributed where the Member reasonably believes the investors receiving the communication have access to resources to independently analyze the information presented, or have the financial expertise to understand the risks and limitations of such presentations. In that context, FINRA stated that a Member could rely on its past experiences with particular types of institutional investors and QP private placement investors who seek this information; persons or entities that have expressed interest in particular types of securities; or those who have invested in similar securities in the past.

Reasonable Basis. The Member would be required to have a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return, and retain written records supporting the basis for such criteria and assumptions. No similar requirement is imposed under the Marketing Rule, although CAB Rule 221 includes a similar requirement.[8] FINRA is proposing to include new Supplementary Material to Rule 2210 that would list some, but not all, of the factors that Members should consider in developing a reasonable basis. Proposed Supplementary Material 2210.01 would provide that, in forming a reasonable basis for the criteria used and assumptions made in calculating projected performance or a targeted return, with no one factor being determinative, Members should consider multiple factors, including, but not limited to:

1. Global, regional, and country macroeconomic conditions (for example, considering potential civil or political instability or weather conditions that may impact projected performance);

[8] CAB Rule 221 currently allows for the use of hypothetical performance, including projected performance and targeted returns. *See* FINRA Regulatory Notice 16-37 (Oct. 17, 2016) (noting that CAB Rule 221 streamlines the requirements of Rule 2210, "essentially prohibiting false and misleading statements").

2. Documented fact-based assumptions concerning the future performance of capital markets;

3. In the case of a single security issued by an operating company, the issuing company's operating and financial history;

4. The industry's and sector's current market conditions and the state of the business cycle (for example, including a consideration of any characteristics unique to the industry and sector, such as the effect of rising mortgage rates on the housing sector);

5. If available, reliable multi-factor financial models based on macroeconomic, fundamental, quantitative, or statistical inputs, taking into account the assumptions and potential limitations of such models, including the source and time horizon of data inputs;

6. The quality of the assets included in a securitization (taking into consideration, for example, the ability to assess the credit quality of underlying assets through available data and the performance of similar pools);

7. The appropriateness of selected peer-group comparisons (for example, the relative similarities or differences among the components of a selected peer group versus the subject issuer, the number of constituents in the peer group, and the reasonableness of the comparison);

8. The reliability of research sources (including, for example, whether there is a relationship between the issuer and the research source that could pose a conflict of interest; whether the research has been subject to peer review before publication; and whether the research is based on reliable or verifiable factual information);

9. The historical performance and performance volatility of the same or similar asset classes;

10. For managed accounts or funds, the past performance of other accounts or funds managed by the same investment adviser or sub-adviser, provided such accounts or funds had substantially similar investment objectives, policies, and strategies as the account or fund for which the projected performance or targeted returns are shown;

11. For fixed income investments and holdings, the average weighted duration and maturity;

12. The impact of fees, costs, and taxes; and

13. Expected contribution and withdrawal rates by investors.

Proposed Supplementary Material 2210.01(b) would not permit Members to base projected performance or a targeted return upon (i) hypothetical, back-tested performance or (ii) the prior performance of a portfolio or model that was created solely for the purpose of establishing a track record.

Disclosure. The communication would be required to disclose prominently that the projected performance or targeted return is hypothetical in nature and that there is no guarantee that the projected performance or targeted return will be achieved. The Member would also be required to provide sufficient information to enable the investor to understand (i) the criteria used and assumptions made in calculating the projected performance or targeted return, including whether the projected performance or targeted return is net of anticipated fees and expenses; and (ii) the risks and limitations of using the projected performance or targeted return in making investment decisions, including reasons why the projected performance or targeted return might differ from actual performance. These requirements correspond to the disclosure requirements for private fund and investment adviser marketing materials that contain projected or target performance imposed by the Marketing Rule.[9] In contrast, these requirements are not currently included in the corresponding CAB rule.

In explaining the disclosure requirements, FINRA stated that Members would not be required to disclose proprietary or confidential information, but would be expected to provide a general description of the methodology used sufficient to enable the investors to understand the basis of the methodology, as well as the assumptions underlying the projected performance or targeted return. Similarly, FINRA stated that a communication may need to disclose that the projection does not reflect actual cash flows into and out of an investment portfolio, such as where a projection is expressed as an internal rate of return.

General Standards Under Rule 2210

In the description of the Proposal, FINRA reminded Members that communications that contain projected performance or targeted returns must also meet Rule 2210's general standards, including the requirements that communications be fair and balanced, provide a sound basis for evaluating the facts in regard to any particular security or type of security, and not contain false, exaggerated, unwarranted, promissory or misleading content. The general standards of FINRA Rule 2210 are similar to, though not fully aligned with, the general prohibitions applicable to registered investment advisers under the Marketing Rule.[10]

FINRA stated that any communication containing a projection or targeted return would be prohibited from presenting exaggerated or unwarranted projections or targeted returns. FINRA believes this constraint would prohibit a Member from presenting a projection that purports to show, for example, longer term returns for an equity security offered shortly before or after the date of the communication, as it would be viewed as unwarranted and lacking a sound basis due to the difficulty in predicting future securities markets and economic conditions. Members' supervisory procedures to review institutional and retail communications[11] would need to include the review of projections of performance or targeted returns, including compliance with the Proposal's specific conditions. In this regard, materials distributed only to QPs might still be retail

[9] Advisers Act Rule 206(4)-1(d)(6)(ii) and (iii).

[10] Advisers Act Rule 206(4)-1(a).

[11] FINRA Rule 2210(a)(5) defines "retail communication" as any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. FINRA Rule 2210(a)(6) defines "Retail investor" as any person other than an institutional investor, regardless of whether the person has an account with a Member.

communications as QPs could include natural persons or other investors who are not institutional investors for purposes of FINRA Rule 2210. Members would need to have a registered principal review and approve the use of communications sent to more than 25 QPs that are non-institutional investors over a 30-day period.

FINRA noted that Members that use third-party vendors to perform core business or regulatory oversight functions must establish and maintain a supervisory system, including written supervisory procedures, for any activities or functions performed by third-party vendors that are reasonably designed to ensure compliance with applicable securities laws and regulations and with applicable FINRA rules. Accordingly, FINRA believes that a Member relying on third-party models or software to create a projection or targeted return would be expected to establish and maintain a supervisory system reasonably designed to ensure that any projections or targeted returns created by a third-party vendor are consistent with the Proposal's requirements. For example, the Member would need to ensure that there is a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return and would need to retain written records supporting the basis for such criteria and assumptions. FINRA believes that a Member should make reasonable efforts to determine whether the model or software is sound and make reasonable inquiries into the source and accuracy of the data used to create the projection or targeted return. If the Member has reason to suspect that the third-party model or software lacks a sound basis, FINRA believes the Member should investigate the matter and, if it cannot be reasonably assured that the model or software is sound, must not use it. Among factors FINRA identified for Members to evaluate the third-party model or software are the assumptions used to create the projection or target; the rigor of its analysis; the date and timeliness of any research used to create the model or software; and the objectivity and independence of the entity that created the model or software.

Finally, FINRA also noted that a Member using a projection of performance or targeted return in connection with a recommendation of a securities transaction or an investment strategy involving securities to a retail customer would be required to satisfy Regulation Best Interest (in addition to FINRA Rule 2210).

Observations

The Proposal is a welcome acknowledgment by FINRA of the divergence between FINRA Rule 2210 and both the Marketing Rule and the CAB rules as well as the disparity of information that can be provided to prospective investors depending on whether marketing materials are distributed by a FINRA full-service Member or an investment adviser or CAB. This is particularly relevant in the case of private funds, where prospective investors who are solicited without the involvement of a full-service FINRA Member are permitted to receive performance information, including related, extracted, predecessor, and hypothetical performance, that a full-service FINRA Member might not be able to include in its marketing materials for the same products.

While the Proposal is a helpful step in the right direction, FINRA declined this opportunity to further harmonize FINRA Rule 2210 with the Marketing Rule. It will be interesting to see whether FINRA receives and responds positively to comments

requesting that FINRA Rule 2210 be amended to permit broadly the use of related, extracted, and predecessor performance as is permitted under the Marketing Rule and FINRA's own CAB Rule 221, especially given FINRA's goal of incentivizing issuers to use broker-dealers to offer and sell their securities.

The reasonable basis requirement is the most significant difference between relevant provisions of the Marketing Rule and the proposed changes to FINRA Rule 2210. It is unclear to what extent the SEC's expectations for registered investment advisers in their compliance with the Marketing Rule will align with FINRA's expectations for Members in their compliance with the Proposal, notwithstanding FINRA's stated desire to create uniformity among the two standards. In addition, the reasonable basis requirement appears to pose distinct challenges for a Member that is distributing projected performance and targeted return information that is calculated by the sponsor or manager of a private fund or another third party. In such circumstances, the Member might ultimately be dissuaded from including the projected performance or targeted return in its communication with institutional investors or QPs, despite FINRA's stated intent that the Proposal allow Members to provide this type of information to those investors.

It is also unclear why FINRA decided to limit the use of performance projections and targeted returns to funds that are offered only to QPs. FINRA's proposed approach might reflect a concern that information about performance projections and targeted returns might be indirectly distributed to non-QPs, though FINRA guidance in other contexts does not seem to reflect similar concerns.[12] It seems that QPs would equally benefit from the receipt of information about performance projections and targeted returns regardless of the type of private fund, and that FINRA's concerns about indirect distribution to non-QPs could be addressed by clearly labeling the materials for QPs only and instructing QPs who receive the materials not to provide them to non-QPs. This refinement could be added not only to FINRA Rule 2210 but also to CAB Rule 221. Moreover, FINRA's approach in the Proposal might be of limited utility where a private fund is made available to knowledgeable employees, which might not be QPs.

Publication of the Proposal provides an important opportunity for full-service broker-dealers and private fund advisers who rely on full-service broker-dealers to comment on how FINRA Rule 2210 could be amended to ensure that Members can provide the types of information often requested and expected by QPs and other sophisticated investors to make informed investment decisions. As noted above, comments on the Proposal are due on or before December 15, 2023, and the SEC will need to approve the Proposal.

[12] *See* Interpretive Letter to Jason P. Ellison, Foreside Fund Servs., LLC (Sept. 1, 2020); Interpretive Letter to Joan E. Boros, Esq., Stradley Ronon Stevens & Young, LLP (Apr. 16, 2018); Interpretive Letter to Clair Pagnano, K&L Gates LLP (June 9, 2017); Interpretive Letter to Edward D. Macdonald, Hartford Funds Distributors, LLC (May 12, 2015).

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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