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Client Alert

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FINRA Proposal Allows Selective Custom Performance Projections in Marketing Materials

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Current Financial Industry Regulatory Authority (FINRA) rules restrict registered broker-dealers from including certain types of performance projection market materials for funds and other securities they sell. FINRA has recently proposed, however, to liberalize these restrictions.

The proposed amendments would create an explicit exception to certain prohibitions on performance projections so as to permit FINRA member broker-dealer firms to, subject to certain conditions being satisfied, distribute various types of customized hypothetical investment planning illustrations that include the projected performance of an asset allocation or other investment strategy.

Background

Under current FINRA Rule 2210(d), all FINRA member communications must be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts. No member may omit any material fact if the omission would cause the communications to be misleading. The general prohibition against performance projections is largely intended to protect retail investors from performance projections of individual investments, which may "prove to be spurious, inaccurate or otherwise misleading."

FINRA Rule 2210 also sets forth various, more specific limitations, including a prohibition on communications that "predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." The rule does, however, allow for:

1. "A hypothetical illustration of mathematical principles, provided that it does not predict or project the performance of an investment or investment strategy;

2. The use of certain investment analysis tools or reports written by such tools; and

3. Certain price targets contained in research reports."

The FINRA Proposal

The proposal would provide an exception to the prohibition of projections for customized hypothetical investment planning illustrations. FINRA Regulatory Notice 17-06 provides that a "customized" investment planning illustration is one designed for a particular client or multiple clients who share an account. 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 prior FINRA guidance.

The exception would be available to all FINRA member firms and could be used with both current and prospective customers, with performance projections being permitted to illustrate an asset allocation or other investment strategy, but **not** the performance of an individual security.

The proposal would require that there be a reasonable basis for all assumptions, conclusions and recommendations, and that the illustration clearly and prominently disclose that any included illustrations are hypothetical and that there is no assurance that any described investment performance or event will occur.

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. Material assumptions and limitations applicable to the illustration would also have to be disclosed.

The proposal would also 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.

The FINRA proposal may alleviate some of the conflict that has existed in performance advertising rules under the Investment Advisors Act of 1940 and FINRA rules. SEC investment advisers are not governed by FINRA advertising-related rules but rather by, among other things, Section 206(4) of the Investment Advisors Act of 1940 and Rule 206(4)-1. While Rule 206(4)-1 specifies certain advertising practices deemed to be fraudulent, deceptive or manipulative, it is generally interpreted to be more permissive than FINRA Rule 2210.

Moreover, past FINRA enforcement precedents with respect to performance advertising have been somewhat inconsistent, resulting in uncertainty in the industry. For example, some enforcement actions have suggested that targeted returns may be used in marketing materials so long as they are adequately substantiated and provide investors with a basis for evaluating the target information, while others assume that such statements are virtually always a violation of Rule 2210. Accordingly, the current proposal may help clarify FINRA's position on the subject to some degree.

The FINRA proposal may also benefit investors. In that regard, illustrations concerning asset allocation or other investment strategies could serve as a useful tool to better inform investors about assumptions on which the investment strategies are based. Illustrations may also serve as a statement of intended risk-taking by a manager, and therefore function as material disclosure information for investors.

There are limitations in the proposal, however, that may limit its usefulness. Hypothetical investment planning illustrations that include projected performance may not be centered on a single security and the illustrations must also be "customized" (i.e., designed for a particular client or multiple clients who share an account). We would therefore expect that practical use of customized illustrations would be limited to a select number of situations and types of customers (i.e., presentations to assist high net worth clients, where the time to prepare custom reports might make economic sense) as well as part of high-tech online financial planning tools. We would not expect the proposal to greatly assist "retail" investors.

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