

## Comments on FINRA's Proposed Amendments to Rules Governing Communications with the Public

### BUSINESS LAW SECTION SECURITIES REGULATION COMMITTEE

BLS #2

March 30, 2017

Ms. Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington DC 20006-1506

Re: Regulatory Notice 17-06 – Request for Comments on Proposed  
Amendments to Rules Governing Communications with the Public

The Securities Regulation Committee of the Business Law Section of the New York State Bar Association appreciates the invitation from FINRA in Regulatory Notice 17-06 to comment on FINRA's proposal to amend the Communications Rules.

The Committee is composed of members of the New York State Bar Association, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and corporation law departments. A draft of this letter was reviewed by certain members of the Committee. The views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association or its Business Law Section.

#### INTRODUCTION

Forecasts and projections (in this letter, "projected performance" or "projections") have a place in securities offerings and securities advice. As the Regulatory Notice points out, "the Investment Advisers Act does not prohibit the presentation of projections that comply with the antifraud provisions of the Act."

Section 27A of the Securities Act of 1933 ("Securities Act") and Section 21E of the Securities Exchange Act of 1934 each provide a safe harbor for forward-looking statements that meet the requirements of those sections, specifically to encourage issuers to make forward-looking financial information available to the public. Certain private fund managers use projections in their offering materials and, for some types of investments, such as real estate funds, institutional investors and other sophisticated investors expect to receive projected performance information.<sup>1</sup>

---

<sup>1</sup> See Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune*

Projections that have a reasonable basis are useful informational tools, when used with other types of information. We believe that, as a general matter, member firms should not be prohibited from using projections that have a reasonable basis. However, we support the proposal to permit the projected performance of an asset allocation or other investment strategy in a customized hypothetical investment planning illustration, and urge FINRA to specifically permit a member to recommend a security, such as an exchange-traded fund (“ETF”), that tracks or represents an asset allocation or investment strategy. We also urge FINRA to permit all FINRA member firms to use projected performance with institutional investors and qualified purchasers, as capital acquisition brokers (“CABs”) will be permitted to do when the CAB rules go into effect in April. We discuss these two points below.

## **DISCUSSION**

### *Public and Private Funds as Asset Allocation or Investment Strategies*

At the end of the Regulatory Notice, FINRA requests comments in seven specific areas. In the sixth request, FINRA asks whether there are “single investment products that operate like an asset allocation or other investment strategy for which performance projections might be appropriate.” The answer is yes. All public and private funds embody an asset allocation or investment strategy; the relevant question is whether the asset allocation or investment strategy is sufficiently transparent and predictable<sup>2</sup> to provide a reasonable basis for projected performance.

Registered investment companies, whether ETFs or open-end funds, that track stock indexes provide a high degree of transparency and predictability about how the assets of the fund will be invested. Sector funds, which invest in specific business sectors, can also have a great degree of transparency and predictability about how their assets will be invested. If a broker can provide projected performance with a reasonable basis about an index or business sector, and there is a fund that closely tracks the index or sector, the broker should be able to recommend the purchase of securities in the fund as a way to replicate the performance of the index or sector.

Unit investment trusts (“UITs”) are investment companies that operate as closed-end funds: they disclose the portfolio of securities or assets they intend to buy, close the offering when the disclosed offering amount has been raised, and purchase the assets. UITs do not generally make additional investments after they begin operation, and management is generally limited to making

---

*Tellers or Rebirth of Secondary Liability?*, 28 J. CORP. L. 69, 98–99 (2002) (noting that investors seek forward-looking information because “the whole point of investing is to move current wealth forward through time”); Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1197 (1970) (observing that “members of the financial community determine the value of a security by the capitalization of projected future income”); Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 931 (2005) (“The investing public craves the release of forward-looking information from corporations because it provides investors with guidance in formulating investment decisions based on the future expectations of companies.”). *See also*, Lanny Schwartz and Hilary Seo, *Targeted Returns under FINRA’s Communications Rules*, N.Y.L.J. (Mar. 24, 2014) (investors naturally expect to see targeted returns as part of their evaluation of fund investments).

<sup>2</sup> The term “predictable,” as used here with respect to an asset allocation or investment strategy, refers to how the strategy will be applied in the future, not the predictability of performance of the strategy. For example, an investment strategy that will track the Dow Jones Average, rebalancing periodically as required, is highly predictable with respect to implementation of the strategy.

decisions about when to sell assets. The asset allocation in a UIT is transparent and predictable. In this case as well, if a broker is able to provide reasonable-basis projected performance for the assets to be purchased by the UIT, the broker should be able to recommend the UIT shares as a way to achieve the performance of the assets.

There are private funds that provide similar transparency and predictability about their asset allocation and investment strategy. This is true of private real estate funds that disclose the real estate properties to be purchased, and real estate funds that operate in a specific sector, such as triple net leased office buildings or storage facilities in a particular geographic area. Similarly, private equity funds that target companies with a specified maturity in specific businesses, such as health clubs, locksmiths or florists, and in specific geographic areas, can also offer transparency and predictability about their asset allocations. Here again, if a broker can provide a reasonable-basis predicted performance with respect to the assets or sector in which the fund will invest, the broker should be able to provide projected performance information about the fund.

In each of the situations described, the key tests should be whether the asset allocation or investment strategy of the fund is transparent and predictable, and whether there is a reasonable basis for projecting the performance of the asset allocation or investment strategy.

#### *Use of Predicted Performance with Institutional Investors and Qualified Purchasers*

The Notice states that “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.” (Emphasis added.) FINRA has recognized in a number of contexts, such as the Suitability Rule, the filing and supervision provisions of the Communications Rule and, most recently, in the CAB rules, that institutional customers do not require the same protections as retail customers.

CAB Rule 221, governing communications with the public, does not prohibit a CAB from using forecasts or projections. One justification for this difference between the CAB rules and the rules applicable to other FINRA members is that a CAB may sell securities in private placements only to institutional investors as defined in Rule 016(i). That definition includes familiar categories of institutional investors, like banks, insurance companies, investment companies and employee benefit plans. It also includes any person (individual or entity) that has total assets of at least \$50 million and any “qualified purchaser” as defined in Section 2(a)(51) of the Investment Company Act of 1940.

Regular FINRA members should have the same freedom to provide projected performance information to Rule 016(i) institutional investors as CABs, not merely for reasons of competitive fairness and equal treatment, but because the same fundamental principle applies: institutional investors have sufficient sophistication to evaluate the projected performance and the weight to be given to it in the overall investment decision.

In the Notice, FINRA addressed the anticipated benefits of the proposed amendment which include, inter alia, that such projections “could better inform investors about the recommended investment strategies, including the underlying assumptions upon which the recommendations are based.” FINRA further noted that it “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.” We would add that a principal objective of the securities laws, and the Securities Act in particular, is to ensure that investors have adequate information to enable them to evaluate prospective investments.

We are aware that, while FINRA permits the use of some related performance information in offerings to institutional customers only, FINRA has not permitted information prohibited for use with retail customers to be provided to institutional customers in offerings to both institutional and retail customers.<sup>3</sup> As previously noted, we believe that reasonable-basis projected performance should be permitted for use with retail as well as institutional customers, as part of a complete mix of relevant and material information thereby aligning with the basic objectives of the Securities Act and satisfying the additional benefits proposed by FINRA. However, if FINRA continues to be concerned about the use of projected performance in sales material prepared by brokers (as distinguished from material prepared by issuers) FINRA should, at a minimum, permit the use of reasonable-basis projected performance in broker material distributed in securities offerings made exclusively to Rule 016(i) institutional investors. This would include all offerings of private funds exempt under Section 3(c)(7) of the Investment Company Act. It would also include offerings of investment company and REIT shares, as well as other securities, that, pursuant to the offering terms, are available for purchase exclusively by Rule 016(i) institutional investors. Finally, wholesale brokers who deal exclusively with institutional intermediaries such as other brokers and investment advisers should be permitted to provide projected performance information to those intermediaries, even in offerings in which retail investors may participate, in a manner consistent with the interpretive letter on related performance information provided to Hartford Funds Distributors, LLC (May 12, 2015).

## **CONCLUSION**

We propose permitting brokers to (1) make reasonable-basis projections about an asset allocation or investment strategy and then to recommend securities that implement that strategy in a transparent and predictable manner and (2) provide reasonable-basis projections to Rule 0161(i) institutional investors in offerings exclusively to those investors. We believe that amending the content standards of Rule 2210 in that way will enable brokers to provide higher quality information to investors in a way that is consistent with the principles of investor protection.

We would be happy to discuss these comments with you or the use of projected performance generally, at your request.

Chair of the Committee : Anastasia Rockas, Esq.

Drafting Committee:  
Peter W. LaVigne, Chair  
Salim Katach  
Kristine Koren  
Marcia B. Moulon-Atherley  
Morris Simkin

---

<sup>3</sup> Letter to Collins/Bay Island Securities (Sept. 14, 2004).