# Regulatory Notice 08-77

# Customer Account Statements

## FINRA Provides Guidance on Estimated Annual Income and Estimated Yield

### Executive Summary

In recent years, broker-dealers have begun to provide estimates of income, dividend and yield information concerning specific securities in their customers' accounts. According to some broker-dealers that prepare and distribute customer account statements, customers consider this information important data in their customer account statements. Some customers may use the estimated annual income (EAI)[1] and estimated yield (EY) to monitor and review the income and yield of securities they hold, while other customers may use EAI as a financial planning tool to estimate annual cash flow. FINRA is concerned that some customers might confuse EY with the actual performance of their investments, although EY is not designed to depict total investment returns or actual yields.

This *Notice* provides guidance on how broker-dealers can best meet their responsibilities with respect to the presentation of estimated annual income and estimated yield in customer account statements. FINRA strongly encourages all broker-dealers that present EAI and EY in customer account statements to review this *Notice* carefully and take any necessary action.

Questions concerning this *Notice* should be directed to Tom Pappas, Vice President and Director, Advertising Regulation, at (240) 386-4553.

FINRA™

Financial Industry Regulatory Authority

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### Notice Type

- Guidance

### Suggested Routing

- Compliance
- Registered Representatives

### Key Topic(s)

- Customer Account Statements
- Estimated Annual Income
- Estimated Yield

### Referenced Rules & Notices

- NASD Rule 2210

## Background & Discussion

Broker-dealers voluntarily provide estimated annual income (EAI) and estimated yield (EY) in customer account statements for a wide variety of securities that produce income, such as dividend-paying common stock, preferred stock, bonds, mutual funds, unit investment trusts, closed-end funds, direct participation programs and collateralized mortgage obligations.

The manner in which EAI and EY are presented in customer account statements could raise a variety of regulatory concerns. By their very nature, EAI and EY merely "estimate" the income that a particular security will distribute every year, and the yield based on that estimated annual income and current price. This estimation of annual income and yield is often rough. If a customer trades the shares, then the number of shares that are owned at the time the statement is produced, a factor in the calculation of EAI, may vary from the number that will be held in the future. If the amount or frequency of an issuer's dividend payments fluctuate, then the actual income and yield of the security will fluctuate accordingly.

EAI does not reflect the amount of income that the customer has already earned during the previous year from a particular security, and EY does not reflect the yield that the customer has already earned on that security. The number of units or shares that the customer owns at the time the statement is produced, a factor in the calculation of EAI and EY, may not be the same number that the customer owned throughout the year. Additionally, a decline in the share or unit price of a security, such as a bond fund share, will typically cause the EY to increase.

## Data Vendors

Vendors that compile dividend and income data relevant to particular securities supply the dividend and income information to broker-dealers. In some cases, the vendor uses this data to calculate EAI and EY for their broker-dealer customers. In other cases, broker-dealers use this data to calculate EAI and EY themselves.

Broker-dealers that include EAI and EY on customer account statements should be familiar with the criteria imposed by their vendors in order to understand the types of data they will receive and the extent to which the conversion of that data into EAI and EY is reasonable.

The vendors often impose their own criteria on when they will provide the data to broker-dealers or when they will calculate EAI and EY. For example, a vendor may provide a broker-dealer with an indicated annual dividend (IAD) calculated by using either a projected or historical methodology. In a "projected" methodology, the vendor uses the latest regular cash dividend and the number of scheduled payments in any twelve-month period to determine the IAD; this is often the method used for equities. In a "historical" methodology, the vendor bases the IAD on the accumulated regular cash dividends paid during the previous twelve months or some other recent historical time period. The EAI is then derived by multiplying the total units of a given security in a customer's account by the annual interest or dividend figure for that security. EY typically is calculated by dividing the EAI by the product of (1) the price per share or unit owned and (2) the number of shares or units owned.[2]

Therefore, broker-dealers should be familiar with those criteria, and should:

- Request that their vendor provide them with the methodology used to derive dividend, income and yield data and require the vendor to update the broker-dealer if, and when, the vendor makes a significant change to this methodology.
- Request that their vendor provide them with the manner in which the vendor classifies specific data (such as classification of income as capital gains, income or return of principal), the source of the data, and the manner in which dividend, income and yield data provided by the vendor are computed. Such computation information should provide sufficient detail for the broker-dealer to assess the appropriateness of the data for presentation or as the basis for computation of EAI or EY in a customer account statement.
- To the extent feasible, include a requirement that the vendor provide this information in the broker-dealer's contract with the vendor.

## Disclosure

Consistent with the standards of NASD Rule 2210(d)(1), broker-dealers should present EAI and EY in a fair and balanced manner and provide an appropriate context in which customers can evaluate this information. For example, the presentation of EAI and EY on customer account statements should be clearly distinguished from income received by the customer or the performance of a security (*e.g.*, total return or actual yield). Language used to describe EAI and EY should not create confusion about the type, characteristics or significance of the EAI and EY information being presented.

FINRA is particularly concerned with the reclassification of previously issued dividends as a return of principal with respect to some securities, such as closed-end investment companies, direct participation programs and real estate investment trusts. Even when the vendor or product sponsor, and not the broker-dealer, makes this reclassification, the resulting EAI and EY figures could confuse customers.

In order to help customers more clearly understand EAI and EY, broker-dealers should, at a minimum, provide in substance the following disclosure in customer account statements that present EAI and EY data:

- EAI and EY for certain types of securities could include a return of principal or capital gains in which case the EAI and EY would be overstated.
- EAI and EY are estimates and the actual income and yield might be lower or higher than the estimated amounts.
- EY reflects only the income generated by an investment. It does not reflect changes in its price, which may fluctuate.

## Calculation Methodologies

Broker-dealers are responsible for using a method to calculate EAI and EY that is reasonable given that customers may rely on this information. The presentation of EAI and EY should reflect any change that can be reasonably known about a security, such as a scheduled change to the coupon rate of a debt security or a change in the dividend paid by an equity security.

Several circumstances could undermine a broker-dealer's ability to meet its responsibilities to present EAI and EY in a fair and balanced manner, such as the inclusion of a special one-time dividend in the EAI calculation, which by its nature, is not expected to recur. Other examples include calculating EAI for:

- A security that does not pay a dividend on a regular basis.
- An issue in default.
- A fixed income security that has paid its last coupon prior to maturity.

If the broker-dealer believes there is a high probability that these concerns will arise and can not address the concerns by reasonably designed procedures, providing EAI or EY usually would not be appropriate.

## Endnotes

1 For purposes of this *Notice*, income and dividend information are referred to as "estimated annual income".

2 EAI is typically calculated as follows:

EAI = S*IAD

Where:

- S = number of shares or units owned on the day of the calculation; and
- IAD = the indicated annual dividend.

For example, if a customer owns 100 shares of an equity security for which the announced quarterly dividend is $.30 per share, then the customer's EAI will be presumed to be $120 per year (100 shares * $1.20).

EY is typically calculated as follows:

EY = EAI/(Ps * S)

Where:

- EAI = Estimated Annual Income;
- Ps = Price per share or unit owned on the day of the calculation; and
- S = Number of shares owned on the day of the calculation.

For example, if a customer owns 100 shares of an equity security and has an EAI of $100 and if the price of each share as of the day of the calculation is $15, then the customer's yield would be presumed to be 6.7 percent. This is derived from the following calculation: $100 ÷ ($15*100) = .067.