

Revised FINRA Rules Regarding Communications with the Public Adopted

BY THE INVESTMENT MANAGEMENT PRACTICE

New rules revamp categories of communication from six down to three. Social media and internal communications not subject to pre-use approval or filing requirements. Closed-end fund communications included within the scope of the rules.

Overview

The U.S. Securities and Exchange Commission ("SEC") has approved a significant revamping of the Financial Industry Regulatory Authority's ("FINRA") current rules regarding communications with the public (the "FINRA Communications Rules"). These rule changes complete a multi-year effort by FINRA to reorganize and simplify its Communications Rules and to incorporate into those Rules much of its Interpretive Materials under former NASD Rules 2210 and 2211. The revised FINRA Communications Rules also include some substantive changes, particularly regarding such items as the definition of correspondence, the Rules' application to closed-end funds, and the manner in which illustrations regarding tax-free compounding are presented. The final FINRA Communications Rules also address a number of industry concerns regarding the treatment of internal communications and the use of social media. The revisions to the FINRA Communications Rules will be published in a Regulatory Notice to be issued by FINRA within the next 90 days. That Regulatory Notice will also announce a date by which FINRA member firms ("Members") must comply with the new requirements of the FINRA Communications Rules, which date will be within one year of the SEC's approval of these rules (or no later than March 29, 2013).¹

The changes create a new rule, FINRA Rule 2210, which will replace existing NASD Rule 2210 and will encompass within it NASD Interpretive Materials 2210-1, 2210-4, and much of Incorporated NYSE Rule 472. The remaining Interpretive Materials that currently follow NASD Rule 2210 will now be replaced by FINRA Rules 2212 through 2216. Therefore, the new FINRA Communications Rules now include:

- FINRA Rule 2210 (Communications with the Public),
- FINRA Rule 2212 (Use of Investment Companies Rankings in Retail Communications),
- FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings),
- FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools),

- FINRA Rule 2215 (Communications with the Public Regarding Security Futures), and
- FINRA Rule 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs)).

This Client Alert discusses the key changes addressed in the new FINRA Communications Rules applicable to Members and relating to communications involving registered investment companies.

New Communication Categories

One of the most significant changes brought about by the new FINRA Communications Rules is the consolidation of the number of communication categories from six to three. Under new FINRA Rule 2210, these three types of "Communications" consist of:

- Institutional Communications - "Institutional Communication" means any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a Member's internal communications. This category includes material that previously fell within the definition of "institutional sales material." In addition, the definition of "institutional investor" has been expanded to include multiple employee benefit plans and qualified plans offered to employees of the same employer with, in the aggregate, at least 100 participants (but does not include the participants of such plans).

Importantly, following significant industry concerns, FINRA did not adopt its original proposed definition of "Institutional Communications," which would have included as institutional communications internal communications intended to educate or train registered persons about the products or services offered by the firm. Under that original proposal, Members' internal e-mails and other materials relating to products and services would have been subject to the content standards of FINRA Rule 2210(d)(1) and the review, recordkeeping, and pre-approval requirements that apply to other institutional communications. While acknowledging industry concerns in this area, FINRA reminded Members in the Notice that internal communications, including those to train and educate registered representatives, will still be governed by NASD Rule 3010 (supervision rule). FINRA has stated, however, that it believes that a firm's supervisory scheme would be deficient unless its policies and procedures were reasonably designed to ensure that internal communications are fair, balanced, and accurate.

The Notice also states that FINRA has determined not to impose an affirmative obligation on Members to inquire as to whether institutional communications are being forwarded to "retail investors" each time such a communication is distributed. Nevertheless, FINRA notes that Members are required to have policies and procedures in place to provide reasonable assurance that institutional communications are not being improperly used. For example, FINRA suggests Members obtain "periodic" assurances from institutional investors that they will not forward institutional communications to retail investors. If a Member or its associated persons learns of such forwarding, the Notice states that the Member must treat future communications sent to that institutional investor as retail communications. One particular area of concern pertains to funds sold through intermediary broker-dealer firms, in which an intermediary firm may use institutional communications prepared by a member with its associated persons or retail investors. FINRA notes that if red flags indicate that a recipient broker-dealer has used or intends to use institutional communication with retail investors, the member must follow up on those red flags and, if it determines that this is the case, discontinue distribution of the communication to that recipient broker-dealer until the member reasonably concludes that the broker-dealer has adopted appropriate measures to prevent future redistribution.

- Retail Communications - "Retail Communication" means any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period. "Retail investor" is defined as any person other than an institutional investor, *regardless of whether the person has an account with a member.*

Retail communications include material that previously fell within the definitions of "advertisements," "sales literature," "independently prepared reprint," and "public appearances," if distributed to more than 25 retail investors in a 30-calendar-day period. Importantly, retail communications now also include information that is sent to more than 25 retail *customers* within a 30 day period. Previously, communications sent only to retail customers were generally considered to be "correspondence."

As discussed below, the new FINRA Communications Rules provide relief from the principal pre-approval requirements for market letters (defined as communications that are excluded from the definition of "research report"), if those letters are supervised in the same manner as correspondence. However, the Notice reminds Members that if a retail communication makes "any financial or investment recommendation," an appropriately qualified registered principal must pre-approve the material, even if such communication is excluded from the definition of research report. New FINRA Rule 2210 also treats "interactive electronic forums" as retail communications (such forums previously fell within the now eliminated category of public appearance), as well as "independently prepared reprints" (previously their own category of communications), but again the new Rules provide relief from the filing and pre-approval requirements for such material as discussed below.

- Correspondence - "Correspondence" means any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30-calendar-day period.

Generally, communications that previously qualified as "correspondence" will continue to fall within that definition under the new Rules, with the exception noted above for communications sent to more than 25 retail *customers*.

Approval, Review, and Recordkeeping Requirements

Communications Subject to Pre-Use Principal Approval

Under FINRA Rule 2210(b), the pre-use principal approval requirement² will generally apply to all retail communications, with three additional exceptions to those previously in existence. Pre-use principal approval is not required where a retail communication: 1) constitutes a "market letter" (i.e., is excluded from the definition of "research report" unless the communication makes a financial or investment recommendation), 2) is posted on an online interactive electronic forum, or 3) does not make any financial or investment recommendation or otherwise promote a product or service of the Member³, provided in all cases that the Member supervises and reviews such communications in the same manner as required for supervising and reviewing correspondence pursuant to NASD Rule 3010(d).

In addition, FINRA Rule 2210(b) extends the qualified principal approval standard to Supervisory Analysts approved pursuant to NYSE Rule 344 with respect to: (i) research reports on debt and equity securities; (ii) retail communications as described in NASD Rule 2711(a)(9)(A); and (iii) other research that does not meet the definition of "research report" under NASD Rule 2711(a)(9), provided that the Supervisory Analyst has technical expertise in the particular product area.⁴

Recordkeeping

The same recordkeeping rules that previously applied to advertisements, sales literature, and independently prepared reprints will now apply to retail communications and institutional communications generally.

Filing Requirements

FINRA Rule 2210 generally incorporates the current filing requirements of NASD Rule 2210, with certain exceptions.

Pre-Use Filing Requirements

Under FINRA Rule 2210(c)(2), FINRA will expand the current pre-use filing requirement to all retail communications (not just advertisements and sales literature), if pre-use filing is otherwise required under the Rule. For example, FINRA will require pre-use filing (at least 10 business days prior to first use or publication) for all retail communications concerning any registered investment company security that includes self-created rankings, as well as for all retail communications that contain bond mutual fund volatility ratings.

For new Members, FINRA Rule 2210(c)(1) imposes a pre-use filing requirement with respect to certain retail communications for a one-year period beginning on the date that the firm's FINRA membership becomes effective as reflected in the Central Registration Depository ("CRD") system. Importantly, in this circumstance, FINRA has narrowed the new Member requirement to only apply to communications previously defined as "advertisements," e.g., communications published or used in "public media," such as newspapers, print media, television, radio, and generally accessible websites, and not to all retail communications. This will have the effect of limiting the scope of the new Member filing requirement to its prior standards under NASD Rule 2210.

Post-Use Filing Requirements

The post-use filing requirement now applies generally to all "retail communications," including for the first time, all retail communications concerning registered closed-end investment companies, except for press releases issued by closed-end funds listed on the New York Stock Exchange.⁵ In addition, the new Communications Rules retain the exclusion for materials that were previously filed and are used without material change, and also codify existing staff interpretations that exclude from the filing requirements retail communications based on templates that were previously filed, with changes only made to update statistical or other non-narrative information. In addition, the new Communications Rules also exclude from the filing requirements retail communications posted on an online interactive electronic forum, and communications that do not make any financial or investment recommendation or otherwise promote a product or service of the Member, as discussed above.⁶ Other post-use filing requirements and exclusions largely remain unchanged (including, among other things, the exclusion for filing independently prepared reprints, press releases made available only to members of the media, institutional communications, and correspondence).

Content Standards

FINRA Rule 2210 will continue to retain the old content standards, but rather than addressing them in a series of Interpretive Memos that follow the Rule, they will be codified in the Rule itself and in several subsequent Rules. In addition, FINRA made the following substantive changes to the content standards:

Express Ban on Promissory Statements

FINRA will continue to prohibit Members from making “any false, exaggerated, unwarranted or misleading statement.” FINRA Rule 2210 now expressly also bans promissory statements, which, of course, were previously prohibited as “false, exaggerated, unwarranted and misleading.”

Predictions and Projections

FINRA will continue to prohibit the use of performance predictions and projections, but the Communications Rules’ exception for a “hypothetical illustration of mathematical principles” will now also permit “projections of performance in reports produced by investment analysis tools” (if they meet the requirements of FINRA Rule 2214, the successor to Interpretive Material 2210-6). FINRA will also expressly allow Members to provide price targets in debt and equity research reports, as long as there is a reasonable basis for the price target, the valuation method used is disclosed, and the risks that may “impede achievement of the price target” are explained.

Disclosure of Member’s Name

FINRA will retain the old provisions regarding disclosure of a Member’s name to all retail communications, and will extend these same requirements to correspondence.

Illustrations of Taxable and Tax-Deferred Compounding

The current rules applicable to materials that reference tax-free or tax exempt income are largely retained in the Communications Rules with the exception of the manner in which illustrations of tax-free compounding are presented.⁷ Under new FINRA Rule 2210, such illustrations are subject to the following requirements:

1. the illustration must depict both the taxable and tax-deferred investment using the same investment amounts and gross rates of return, which must be less than 10 percent per year;
2. the illustration must use and identify actual federal tax rates;
3. the illustration is permitted (but is not required) to reflect an actual state tax rate, but only if it also discloses that the illustration is only applicable to investors in the identified state;
4. if the illustration is directed to a target audience, the tax rate(s) used must reasonably reflect the tax bracket(s) and tax character (ordinary income or capital gains) of that group;
5. if an investment payout period is included, the effect of taxes in that period must be addressed;
6. the illustration may not “assume an unreasonable period of tax deferral;” and
7. the illustration must, as applicable, make seven specific disclosures, including: (i) the risk associated with the assumed return and the fact that the assumed return is not guaranteed; (ii) the possible effect of losses on the relative advantage of taxable versus tax-deferred investing; (iii) the extent to which tax rates on capital gains and dividends would affect the taxable investment’s return; (iv) the fact that ordinary income tax rates will apply to withdrawals from a tax-deferred investment; (v) its underlying assumptions;

(vi) the potential impact of tax penalties in circumstances such as early withdrawals or non-qualified expenses, if any; and (vii) that an investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision, as the illustration may not reflect those factors.

Testimonials

The original provisions regulating the use of customer testimonials remain intact, with the exception that the new Rule will require disclosure of any payments of more than \$100 in value (instead of payments in excess of a “nominal sum”).

Public Appearances

Although eliminated as a formal category of communications, public appearances are addressed separately in FINRA Rule 2210(f). The Rule expressly makes public appearances subject to the general content standards, as well as certain disclosure requirements regarding the financial interests or other conflicts present when making securities recommendations, although Members recommending investment company securities or variable products would be exempt from these disclosures so long as the communication has a reasonable basis for the recommendation. The Rules also expressly add a requirement that Members adopt written policies and procedures to supervise public appearances, including training, surveillance, and maintaining records of their efforts. Finally, the Rules state that materials used in public appearances (e.g., slides, handouts, scripts) are themselves communications within the meaning of the Rules.

Investment Company Rankings

FINRA Rule 2112 will incorporate the requirements of NASD IM-2210-3, regarding use of investment company rankings, with one material change. Under the new Rule, when a ranking includes more than one class of investment company securities, the communication must expressly disclose that the classes have different expense structures.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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- ¹ The Notice of Rule Change, including three amendments to the original Notice, as well as FINRA's discussion of the new Communications Rules, can be found at SEC Release No. 34-64984 (July 28, 2011), SEC Release No. 34-65663 (November 1, 2011), SEC Release No. 34-66049 (December 23, 2011), and SEC Release No. 34-66681 (March 29, 2011) (collectively, the "Notice"). The Notice of Rule Adoption can be found at www.sec.gov/rules/sro/finra.shtml.
- ² FINRA Rule 2210 also eliminates Incorporated NYSE Rule 472(a)(1), which required an "allied member, supervisory analyst or qualified person" to approve certain public communications for NYSE member firms. The Notice also states that FINRA is separately seeking comment on a proposal that would amend NASD Rule 1022(g) to permit a General Securities Sales Supervisor to approve all retail communications under new FINRA Rule 2210.
- ³ FINRA expects such material to generally consist of communications that are administrative or informational in nature, such as account statement availability or dividend notices. Other materials that presumably also fit in this category include privacy statements. Materials designed to educate investors about products or services are not included in this category.
- ⁴ FINRA notes that this revision is not intended to alter current requirements that certain types of retail communications, such as retail communications concerning options, municipal securities, or security futures, be approved by a principal with a specific qualification.
- ⁵ Current NASD rules require post-use filing only of material distributed during a closed-end fund's initial offering period as well as material concerning continuously offered interval funds.
- ⁶ See Footnote 3 and accompanying text.
- ⁷ FINRA Rule 2210(d)(4)(C).