

FINRA ISSUES INTERPRETIVE GUIDANCE ON RELATED PERFORMANCE IN INSTITUTIONAL COMMUNICATIONS

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U.S. Broker-Dealer Alert

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INTRODUCTION

On June 9, 2017, the Financial Industry Regulatory Authority, Inc. ("FINRA") issued an interpretive letter (the "Letter")^[1] permitting the use of Related Performance Information (as defined below) in continuously offered closed-end registered investment company (the "Fund")^[2] sales materials distributed solely to institutional investors. Related Performance Information is defined in the Letter as the actual performance of separate or private accounts or funds that have (i) substantially similar investment policies, objectives, and strategies; and (ii) are currently managed or were previously managed by the same adviser or sub-adviser that manages the registered investment company that is the subject of communication with institutional investors.

In 2015, FINRA issued an interpretative letter in which it recognized that the use of Related Performance Information in institutional communications relating to open-end registered investment companies would not be inconsistent with the standards of Rule 2210.^[3] Member firms now have additional clarity that the distribution of Related Performance Information in the context of continuously offered closed-end registered investment companies in the manner described below is also permissible.

BACKGROUND

Rule 2210 applies to all written (including electronic) communications "distributed or made available" to retail and institutional investors by member firms. In particular, pursuant to Rule 2210(d) and FINRA interpretations thereof, communications by member firms: must provide balanced treatment of risks and potential benefits;^[4] may not predict or project performance;^[5] and may not include any hypothetical or backtested performance information.^[6] Historically, FINRA has interpreted Rule 2210(d) to restrict members from distributing sales material that included Related Performance Information; however, FINRA has also previously recognized that communications provided solely to institutional investors do not raise the same investor protection concerns as sales materials provided to retail investors. In recent years, FINRA has modified its position to permit member firms to provide Related Performance Information to certain institutional investors, with appropriate safeguards and subject to specified conditions. In 2003, for example, FINRA stated that it would not object to member firms including Related Performance Information in sales material for Section 3(c)(7) funds presented solely to "qualified purchasers" as defined under Section 2(a)(51) of the Investment Company Act of 1940, as amended.^[7] Through the Hartford Letter, FINRA extended similar relief with regard to open-end registered investment companies, including Related Performance Information in communications with institutional investors.

In the Letter at issue, FINRA further extends the rationale and analysis applied in the Hartford Letter to continuously offered closed-end funds with predecessor private accounts or funds.

INTERPRETIVE RELIEF

In addition to complying with all other applicable FINRA rules and federal securities laws, Fund marketing materials containing Related Performance Information purporting to rely on the Letter are subject to the following conditions:

- The materials must be provided only to "institutional investors" as defined in FINRA Rule 2210(a)(4),^[8] excluding institutional investors who intend to share the Related Performance Information with persons other than institutional investors;
- The Related Performance Information must (i) include the actual performance of all separate or private accounts or funds that have substantially similar investment policies, objectives, and strategies of the Fund and are managed or were previously managed by the Fund's investment adviser ("Related Accounts"); (ii) be shown from the inception date of the first Related Account; (iii) be for a period of at least one year and since the inception of the investment strategy; (iv) be current as of the most recently ended calendar quarter; and (v) be clearly labeled as such and contain clear disclosure of the applicable dates for the performance;
- If there are multiple Related Accounts, they must be presented: (i) in a composite; or (ii) with equal prominence in a list;
- Any communication Related Performance Information must be clearly labeled "for use with institutions only, not for use with retail investors," and recipients must be instructed not to provide the communication to current or prospective customers or others who are not institutional investors;
- The Related Performance Information must be shown net of fees and expenses of the Related Accounts and must disclose, if applicable, that the Fund's fees and expenses are lower than those of the Related Accounts and that the Related Performance Information would have been lower had any applicable expense limitations not been taken into account. Gross performance may also be shown, along with required disclosures;
- The fees and expenses of the Fund must be disclosed, and the Fund's actual performance will be shown net of fees. If the fees and expenses are higher than the fees and expenses of the Related Accounts, that fact must also be disclosed; and
- The communication must disclose any material differences between the funds or accounts for which Related Performance Information is provided and the Fund.

FINRA's position that the presentation of Related Performance Information to retail investors does not comply with Rule 2210 remains unchanged by the interpretive relief granted in the Letter.

ANALYSIS AND INTERPRETIVE ISSUES

The relief granted by FINRA in the Letter further assists member firms regarding their compliance with Rule 2210 when using Related Performance Information in registered investment company marketing materials designed for

institutional investors. However, the relief also leaves a number of interpretive questions unanswered. For example:

- Pursuant to the Letter and the Kawata Letter and Hartford Letter, Related Performance Information may now be presented in communications relating to: (1) Section 3(c)(7) funds, provided the recipients are "qualified purchasers"; and (2) registered investment companies, both open-end and continuously offered closed-end, provided the recipients are "institutional investors." However, FINRA has not addressed the use of Related Performance Information in communications regarding other types of securities products, such as Section 3(c)(1) funds or Rule 144A offerings, that require investors to meet standards other than "qualified purchaser" or "institutional investor." Further, if a registered investment company has both retail and institutional investors, providing Related Performance Information only to "institutional investors" creates a potential selective disclosure issue similar to that illustrated by FINRA in its interpretive letter to Budge Collins, Collins/Bay Island Securities.^[9]
- The Letter represents another step in the process toward harmonizing FINRA and SEC advertising standards. For example, registered investment advisers and investment companies are explicitly permitted to provide Related Performance Information to prospective investors under SEC rules and staff guidance.^[10] However, FINRA's guidance applies only to institutional investors. Accordingly, registered representatives of member firms who are also associated persons of a fund's investment adviser ("Dual Employees") must continue to attempt to delineate when they are communicating on behalf of the investment adviser, particularly when communicating with noninstitutional investors.

While the Letter will not result in a fundamental shift in the industry's approach to providing Related Performance Information, it applies the guidance in place for registered open-end investment companies to continuously offered closed-end investment companies in the context of institutional investors. Perhaps more importantly, it also represents FINRA's ongoing recognition that communications provided solely to institutional investors do not raise the same investor protection concerns as communications provided to retail investors, thereby allowing FINRA to interpret its rules in a way that better aligns their investor protection benefits with their impact on member firms and other market participants.

Notes:

^[1] See FINRA Interpretive Letter to Clair Pagnano, K&L Gates LLP, on behalf of Evanston Alternative Opportunities Fund (June 9, 2017).

^[2] A continuously offered closed-end fund differs from open-end management investment companies (commonly known as mutual funds) in that closed-end fund shareholders do not have the right to redeem their shares on a daily basis. In addition, continuously offered closed-end funds differ from traditional closed-end funds because they do not provide liquidity on the secondary market (i.e., a stock exchange), but rather provide liquidity through periodic tender offers for repurchase of shares, typically at net asset value. Shareholders do not have the right to require the continuously offered closed-end fund to repurchase any or all of their shares. Typically, at discretion of the continuously offered closed-end fund's board the fund may provide liquidity by conducting repurchase offers for a portion of its outstanding shares on a periodic basis.

[3] See FINRA Interpretive Letter to Edward P. MacDonald, Hartford Funds Distributors, LLC (May 12, 2015) ("Hartford Letter"). <http://www.klgates.com/finra-relaxes-restrictions-on-related-performance-in-institutional-communications-06-02-2015>

[4] Rule 2210(d)(1)(D).

[5] Rule 2210(d)(1)(F).

[6] NASD Interpretive Letter to Michael D. Udoff, Securities Industry Association (Oct. 2, 2003); FINRA Interpretive Letter to ALPS Distributors, Inc. (Apr. 22, 2013) (permitting pre-inception index performance only in institutional communications regarding passively managed exchange traded products).

[7] NASD Interpretive Letter to Yukako Kawata, Davis Polk & Wardwell (Dec. 30, 2003) ("Kawata Letter").

[8] "Institutional investor" includes a: bank, savings and loan association, insurance company or registered investment company; investment adviser registered either with the Securities and Exchange Commission ("SEC") under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million; a governmental entity or subdivision thereof; an employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of such plans; a qualified plan, as defined in Section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of such plans; a FINRA member or registered person of such a member; and a person acting solely on behalf of any such institutional investor.

[9] See FINRA Interpretive Letter to Budge Collins, Collins/Bay Island Securities (Sept. 14, 2004).

[10] For example, the staff of the SEC's Division of Investment Management takes the position that a registered investment company may include in its registration statement information concerning the performance of separate accounts and other funds managed by the fund's adviser that have substantially similar investment objectives, policies, and strategies as the fund, provided that such information is not presented in a misleading manner and does not obscure or impede the understanding of information that is required to be in the fund's registration statement (including the fund's own performance). See Division of Investment Management IM Guidance Update No. 2013-05 (Aug. 2013); Nicholas-Applegate, SEC No-Action Letter (pub. avail. Aug. 6, 1996); ITT Hartford Mutual Funds, SEC No-Action Letter (pub. avail. Feb. 7, 1997).

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