FINRA RELAXES RESTRICTIONS ON PRE-INCEPTION PERFORMANCE DATA

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U.S. Investment Management and Broker-Dealer Alert

By: Richard F. Kerr, Matthew J. Rogers

INTRODUCTION

On January 31, 2019, the Financial Industry Regulatory Authority, Inc. ("FINRA") issued an interpretive letter (the "2019 Letter") [1] extending previously issued guidance by permitting passively managed open-end registered investment companies including separately managed series of a business trust ("Open-end Funds") to use pre-inception index performance data ("PIP data") in Institutional Communications (as defined below) [2]. In a 2013 Letter (as defined below), [3] FINRA relaxed its historic position that hypothetical back-tested performance is prohibited by FINRA Rule 2210(d) by permitting the use of PIP data for passively managed exchange-traded products ("ETPs") in Institutional Communications when certain conditions are satisfied, but did not extend such relief to passively managed Open-end Funds.

In issuing both the 2013 Letter and the 2019 Letter, FINRA acknowledged that PIP data is often used to model the performance of an index prior to the inception date of a product in order to illustrate how the index would have performed under historical market conditions. The 2019 Letter is a further acknowledgment by FINRA that PIP data can be a valuable method for Institutional Investors (as defined below) [4] that understand the limitations of PIP data to examine historical index performance and levels the playing field between member firms distributing passively managed Open-end Funds and member firms distributing passively managed ETPs.

BACKGROUND

Rule 2210(d) states that no member firm may make any false, exaggerated, unwarranted, or misleading statements in any communication with the public and may not publish, circulate, or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading. FINRA has historically interpreted Rule 2210(d) to prohibit the inclusion of any hypothetical back-tested performance data (including PIP data) in communications with the public by a member firm believing it to be inherently false and misleading in violation of FINRA Rule 2210(d)(1)(B). [5] FINRA has expressed concerns that back-tested performance invariably depicts favorable results, because it benefits from hindsight and components could be selectively used for inclusion in the track record with the knowledge of their performance.

However, in the 2013 Letter, the FINRA staff stated its view that it did not object to the use of PIP data in materials related to ETPs circulated to Institutional Investors, provided that certain specified conditions were satisfied. [6] In articulating this position, the FINRA staff stated that, in determining whether to use PIP data, member firms must be careful to not give such data excess weight and, to the extent the PIP data informs the reader's understanding of a security and its performance characteristics, the member firm must consider the correlation between the PIP data and actual performance for similar ETPs. The FINRA staff also identified certain factors to be considered before using PIP data in an Institutional Communication.

INTERPRETIVE RELIEF

In recognizing the historical overly broad application of FINRA Rule 2210(d) to Institutional Communications, FINRA has further relaxed its position with respect to hypothetical back-tested data to permit PIP data under the conditions set forth in the 2019 Letter. Member firms distributing passively managed Open-end Funds will now be able to provide PIP data with respect to such funds to intermediaries and other Institutional Investors in much the same manner as member firms distributing and marketing passively managed ETPs have been able to since the issuance of the 2013 Letter. To be consistent with the guidance in the 2019 Letter, in addition to complying with all other applicable FINRA rules and federal securities laws, Institutional Communications relating to Open-end Funds containing PIP data are required to comply with the following conditions:

Disclosure Items

- Any materials including PIP data must be labeled "For use with Institutions only, not for use with retail investors." If the recipient is a financial intermediary, the recipient must be instructed not to circulate communications containing PIP data to retail investors. PIP data must also be clearly labeled and shown separately from fund performance and PIP data must reflect the deduction of fees and charges currently applicable to the fund.
- PIP data must be accompanied by the following: (a) the name of the entity that performs the calculation and distribution of the PIP data; (b) disclosure that the PIP data has been applied retroactively with the benefit of hindsight, and actual performance may have varied and that the fund is a relatively new product and any performance prior to the date of inception is hypothetical; and (c) any reasons why the PIP data would have differed from actual performance during the period shown.
- At a minimum, ten years of pre-inception data must be reflected and be current as of the most recently ended calendar quarter. Any PIP data cannot be inconsistent with the information in the fund's prospectus regardless of whether the fund's prospectus contains PIP data. Additionally, for funds that have been in existence for more than one year, net actual performance of the fund since inception must be prominently displayed.

Calculating PIP Data

- Any PIP data may only reflect the performance of a selected index. Such an index must be created according to a pre-defined set of rules that cannot be altered except under extraordinary market, political or macroeconomic conditions.
- Any marketing material containing PIP data must include an offer to provide an overview of the methodology of the index upon request and electronic marketing material must include a hyperlink to such information.

Passive Management

- PIP data may not be used to market the fund if the fund uses or alters its investment strategy to permit active management of the fund's portfolio.

ANALYSIS AND INTERPRETIVE ISSUES

While the 2019 Letter does not alter FINRA's longstanding position prohibiting actively managed products and funds from using PIP data and does not permit PIP data to be distributed in retail communications, member firms involved in the distribution of Open-end Funds will benefit from the 2019 Letter. Since FINRA issued the 2013 Letter, member firms marketing passively managed Open-end Funds have been at a disadvantage to competitor firms marketing similar passively managed ETPs, because they have been unable to provide PIP data to financial intermediaries, including investment advisers, retirement plans, and other broker-dealers. With the issuance of the 2019 Letter, member firms marketing passively managed registered investment companies, whether they are exchange traded or not, will now be on a level playing field. The 2019 Letter is also the latest example in a recent trend by FINRA staff recognizing that communications provided solely to Institutional Investors do not require the same investor protections as communications provided to retail investors and further harmonizes FINRA and SEC advertising standards. [7] Member firms and their affiliates should also be mindful of additional anticipated changes to various advertising rules and requirements which are anticipated in 2019. [8]

The 2019 Letter is an important shift in FINRA staff views on PIP data in Institutional Communications that acknowledges that passively managed Open-end Funds should be treated in a similar manner as passively managed ETPs and will be a welcome development for member firms wishing to include PIP data in marketing materials for the passively managed Open-end Funds they distribute.

NOTES

[1] Interpretive letter to Meredith F. Henning, Foreside, FINRA (Jan. 31, 2019), http://www.finra.org/industry/interpretive-letters/january-31-2019-1200am.

[2] "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. (See FINRA Rule § 2210(a)(3)).

[3] FINRA Interpretive Letter to ALPS Distributors, Inc. (Apr. 22, 2013) (the "2013 Letter" which permits pre-inception index performance only in Institutional Communications regarding passively managed exchange traded products) (available at: http://www.finra.org/industry/interpretive-letters/april-22-2013-1200am).

[4] "Institutional Investors" is defined by FINRA Rule § 2210(a)(4).

[5] *See e.g.*, NASD News Release, "NASD Fines Citigroup Global Markets, Inc. $250,000 in Largest Hedge Fund Sales Sanction to Date" (Oct. 25, 2004).

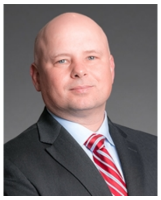
[6] *See* FINRA Interpretive Letter to ALPS Distributors, Inc.

[7] *See* other K&L publications available at: http://www.klgateshub.com/details/?pub=FINRA-Requests-Comment-on-Proposed-Amendments-to-Rules-Governing-Communications-with-the-Public-03-09-2017 and

http://www.klgateshub.com/details/?pub=FINRA-Relaxes-Restrictions-on-Related-Performance-in-Institutional-Communications-06-02-2015.

[8] *See* http://www.klgateshub.com/details/?pub=A-Face-Lift-for-GIPS-CFA-Institute-Publishes-Proposed-Revisions-to-the-GIPS-Standards-in-the-GIPS-2020-Exposure-Draft-10-03-2018 and http://www.klgateshub.com/details/?pub=Calm-Before-the-Storm-Investment-Advisers-Face-Changes-to-the-Advertising-Rule-GIPS-and-Performance-Portability-Standards-05-23-2018.

KEY CONTACTS



RICHARD F. KERR
PARTNER
BOSTON
+1.617.261.3166
RKERR@KLGATES.COM

MATTHEW J. ROGERS
ASSOCIATE
BOSTON
+1.617.951.9147
MATTHEW.ROGERS@KLGATES.COM

