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By Email (pubcom@finra.org)

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

May 23, 2014

Re: Regulatory Notice 14-14: Retrospective Review of Communications with the Public Rules

Dear Ms. Asquith:

We appreciate the opportunity to respond to the request by the Financial Industry Regulatory Authority, Inc. ("**FINRA**") for comments regarding certain of its communications with the public rules (the "**Rules**").[1] K&L Gates LLP is an international law firm that represents a large majority of the major financial institutions, securities, and asset management firms in a variety of disciplines in the major financial centers across the globe. Through its Financial Services practice, K&L Gates LLP advises a broad range of broker-dealers including international, national, and regional firms; retail and institutional brokers; clearing, executing, and prime brokers; M&A advisory firms; proprietary trading firms; alternative trading systems and exchanges; market makers; and broker-dealer affiliates of banks, registered funds, hedge funds, private equity funds, insurance companies, and investment advisers. Our Financial Services practice also represents other financial service providers, such as investment advisers, banks, trust companies, and insurance companies, as well as investment vehicles and other institutional investors, including open- and closed-end registered investment companies (and their independent directors), exchange-traded funds (ETFs), private funds (onshore and offshore private equity, venture capital and hedge funds), commodity pools, business developments companies, retirement plans (ERISA and governmental plans), and collective investment funds sponsored by banks and trust companies. In connection with the

[1] The Rules include FINRA Rule 2210 (Communications with the Public), FINRA Rule 2212 (Use of Investment Company Rankings in Retail Communications, FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), FINRA Rule 2214 (Requirements for Use of Investment Analysis Tools), FINRA Rule 2215 (Communications with the Public Regarding Securities Futures), and FINRA Rule 2216 (Communications with the Public Regarding Collateralized Mortgage Obligations). This letter will focus only on Rule 2210.

public and private offering of interests in such investment vehicles, we regularly advise broker-dealers on a variety of fund distribution and structuring issues raised in the front and back office contexts, including an extensive amount of advice regarding the application of the federal securities laws, the rules and regulations adopted thereunder by the Securities and Exchange Commission ("SEC") and FINRA's rules and interpretations to marketing materials and other communications with the public.

Although our opinions regarding the effectiveness and efficiency of the Rules are informed by our regular discussions with and representation of Financial Services clients, the specific views expressed in this letter do not necessarily represent the views of our clients or all of the attorneys in our Financial Services practice.

I. Introduction

We strongly support FINRA's initiative to engage in retrospective reviews of certain of its existing rule sets to determine whether such rule sets are meeting their investor protection objectives effectively and efficiently in light of current industry and market conditions. We believe that FINRA's reorganization and modification of the Rules in connection with their adoption in the consolidated rulebook[2] simplified their application and provided a number of important clarifications. However, the Rules continue to pose compliance, business and operational challenges for many member firms, particularly for member firms that are dually-registered with the SEC as investment advisers and firms that market and sell interests in registered and unregistered funds. We believe that by implementing the recommendations discussed below, FINRA can ameliorate some of these concerns while continuing to ensure that the Rules serve their intended purpose of protecting investors from false and misleading communications.

II. Comments on Rule 2210

a. Overbroad Application of Content Standards

FINRA Rule 2210 applies to all written (including electronic) communications "distributed or made available" to retail investors and institutional investors by member firms. Although the filing and pre-use approval requirements vary depending on the recipient of a written communication, the content standards contained in Rule 2210(d) apply broadly to all written communications by member firms regardless of the nature of the recipients or the circumstances in which the communications are distributed. In particular, pursuant to Rule 2210(d) and FINRA interpretations thereof, communications by member firms: must provide balanced treatment of risks and potential benefits;[3] may not predict or project performance;[4] and may not include any

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[2] Securities Exchange Act Release No. 66681 (March 29, 2012), 77 FR 20452 (April 4, 2012) (Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of a Proposed Rule Change; File No. SR-FINRA-2011-035).

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

hypothetical or backtested performance information.[5] Further, FINRA has interpreted Rule 2210(d) to restrict members from distributing sales material that includes related performance,[6] with the exception of 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 ("**1940 Act**").[7]

We recognize that the content standards contained in Rule 2210(d) are critical to protecting investors from false and misleading communications. However, in certain contexts, the overbroad application of those standards unnecessarily restricts the business activities of member firms without a corresponding benefit to investors. For example, following an initial marketing effort by a member firm, it is typical for a sophisticated prospective investor considering an investment in a private fund or a privately offered security to enter a "due diligence" phase. During the due diligence phase, the prospective investor frequently requests additional information from the member firm regarding the potential investment, including financial models and projections, backtested performance, and the performance of other similar funds or strategies managed by the same investment adviser. Based on a strict reading of Rule 2210, member firms would be prohibited from providing the requested information, thereby impeding the prospective investor's analysis of the investment.

Further, in situations where a broker-dealer has access to financial projections, related performance information and backtested performance information regarding a potential investment, we believe that FINRA would expect the broker-dealer to consider such information in the context of its reasonable-basis and customer-specific suitability analyses under FINRA Rule 2111. We believe that in this situation, the broker-dealer should be permitted to share that information (appropriately presented and with robust disclosures) with the prospective investor.

This concern is heightened in situations where a member firm (or its affiliate) is proposing to co-invest with the prospective investor, in which case withholding the member firm's internal projections and financial models may run afoul of statutory and regulatory anti-fraud obligations imposed by and under the Securities Act of 1933, as amended ("**Securities Act**"), the Securities Exchange Act of 1934, as amended ("**Exchange Act**"), and, if the member firm is dually registered with the SEC as an investment adviser, the Investment Advisers Act of 1940, as amended ("**Advisers Act**"). Indeed, we are aware that many large, sophisticated investors insist upon receiving the very types of predictive, gross of fees, backtested and related performance information that FINRA rules and interpretations prohibit, thereby leaving member firms in the untenable

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

[5] NASD Interpretive Letter to Michael D. Udoff, Securities Industry Association (Oct. 2, 2003).

[6] "Related performance" generally includes the performance of investment companies, funds, portfolios, accounts or composites thereof that are managed by the same investment adviser, sub-investment adviser or portfolio manager that manages the fund that is being promoted. *See* NASD Interpretive Letter to Yukako Kawata, Davis Polk & Wardwell (Dec. 30, 2003).

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

position of being forced to decide whether to comply with FINRA communications with the public rules or their anti-fraud obligations under the Federal securities laws.

To ameliorate concerns relating to the overbroad application of Rule 2210(d), we recommend that FINRA clarify that the specific restrictions described above do not apply to written communications: (A) provided to an institutional investor; or (B) provided in response to an unsolicited request by a retail investor. An "unsolicited request" should be defined to exclude a (i) request received as a result of any affirmative effort by a member firm that is intended or designed to induce the request; and (ii) communication indicating that the member firm is willing to provide such information upon request. This approach would be consistent with the SEC's interpretation of Advisers Act Rule 206(4)-1(b), which regulates "advertisements" distributed by registered investment advisers.[8] Further, this approach would allow member firms and prospective investors additional flexibility during the due diligence phase of a potential investment without weakening the investor protection objectives of Rule 2210(d). In particular, such communications would remain subject to the requirements that they be based on principles of fair dealing and good faith, be fair and balanced, and not be misleading.

b. Harmonization with Federal Securities Laws and SEC Regulations

Member firms that are dually registered with the SEC as investment advisers, and those that are in a control relationship with one or more registered investment advisers, often struggle to apply two different sets of regulatory standards to their marketing materials. For example, materials promoting an investment strategy offered through a fund are subject to the Rules and applicable FINRA interpretations, while materials promoting an investment strategy through a separately managed account are subject to SEC Rule 206(4)-1 and applicable SEC staff interpretations. The application of FINRA and SEC rules also depends on whether the person distributing the materials is a registered representative of a member firm, an associated person of an investment adviser, or both. This situation leads to compliance challenges for member firms, regulatory risk with respect to the activities of a firm's sales force, and confusion for potential investors. We believe that member firms and investors would benefit from the harmonization of FINRA and SEC advertising standards, particularly in the following areas:

- The staff of the SEC's Division of Investment Management takes the position that a registered fund 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

[8] *See* Investment Counsel Association of America, Inc., SEC No-Action Letter (pub. avail. Mar. 1, 2004).

(including the fund's own performance).[9] Unregistered funds also frequently include related performance in their private placement memoranda or offering memoranda, provided such offering documents are not prepared by a member firm. Member firms are required under SEC and FINRA rules to provide such registration statements and offering documents to purchasers of fund interests. By contrast, while FINRA has previously considered permitting member firms to present related performance information in mutual fund and variable product sales materials, [10] its current position is that member firms may only present related performance information in sales materials for Section 3(c)(7) funds presented solely to qualified purchasers.[11] As a result, the ability of a member firm to present related performance information depends more on the form of the documents provided (e.g., fund prospectuses vs. marketing materials) than their substance. This incongruous outcome creates compliance challenges for member firms without any corresponding benefit to the investing public.

- The SEC staff permits advisers to present model, hypothetical and backtested performance in non-retail communications with adequate disclosure, provided that such performance is not linked to actual performance.[12] By contrast, FINRA expressly prohibits the presentation of model, hypothetical and backtested performance data, even when presented in combination with actual historical performance and regardless of the sophistication of the recipient.[13]

- The SEC staff permits advisers to present gross fund performance (i.e., performance that does not reflect the deduction of advisory fees and other expenses), provided that net of fees performance is also presented with equal prominence and in a format designed to facilitate

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[9] *See* Division of Investment Management IM Guidance Update No. 2013-05 (Aug. 2013); Nicholas-Applegate, SEC No-Action Letter (pub. avail. Aug. 6, 996); ITT Hartford Mutual Funds, SEC No-Action Letter (pub. avail. Feb. 7, 1997).

[10] In 1997, NASD requested comments on a proposed rule that would have allowed the presentation of related performance in mutual fund and variable product sales material. *See* NASD Notice to Members 97-47. The proposed rule change was filed with the SEC in 1998, and subsequently withdrawn in 2004. *See* File No. SR-NASD-98-11.

[11] *See* footnote 7, supra.

[12] *See, e.g.*, Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986); *In re* LBS Capital Management, Inc., SEC Release No. IA-1644 (July 18, 1997); *In re* Schield Management Company et al., SEC Release No. IA-1872 (May 31, 2000); *In re* Meridian Investment Management Corporation et al., SEC Release No. IA-1779 (Dec. 18, 1998); *In re* LBS Capital Management, Inc., SEC Release No. IA-1644 (July 18, 1997); *In re* Patricia Owen-Michel, SEC Release No. IA-1584 (Sept. 27, 1996); *In re* Market Timing Systems, Inc. et al., SEC Release No. IA-2047 (Aug. 28, 2002).

[13] We note that FINRA permits member firms to use backtested performance of an index with institutional investors to promote passively managed exchange traded products. See FINRA Interpretive Letter to Bradley J. Swenson, ALPS Distributors, Inc. (Apr. 22, 2013).

ease of comparison.[14] FINRA provides no such relief for communications by member firms.

- When it adopted FINRA Rule 2210, FINRA modified its standards for communications that include past specific recommendations to mirror those found in Rule 206(4)-1(a)(2) under the Advisers Act. However, FINRA did not incorporate the SEC staff's interpretive guidance under Rule 206(4)-1(a)(2). For example, investment advisers routinely rely upon a no-action letter issued to Franklin Management Inc. that permits them to show past specific recommendations that were selected by objective, non-performance based criteria, subject to specified conditions and disclosure requirements.[15]

As the foregoing examples demonstrate, compliance personnel that support dually registered firms or both member firms and investment advisers are required to constantly delineate adviser marketing materials from broker-dealer marketing materials, and apply the correct content and performance presentation standards to each category of materials. Further, there does not appear to be a clear connection between FINRA's restrictions and the Rules' intended purpose of protecting investors from false and misleading communications, as the SEC has already determined that such restrictions are not necessary to protect potential investment advisory clients (including retail clients). We therefore believe that the variance between FINRA and SEC standards described above create additional compliance costs and regulatory risks for member firms without corresponding investor protection benefits, and we urge FINRA to work with the SEC toward the adoption of a harmonized advertising regime. In that regard, we recommend that FINRA consider, at a minimum:

- Permitting the use of related performance information in marketing materials for registered open-end and closed-end investment companies and funds excepted from the definition of "investment company" pursuant to Sections 3(c)(1), 3(c)(5), 3(c)(7) and 3(c)(11) of the 1940 Act;

- Permitting the use of model, hypothetical and backtested performance information, with appropriate robust disclosures and accompanied by actual performance (when available), in communications with institutional investors;

- Clarifying that FINRA members may present gross performance side-by-side with net performance, subject to the conditions of the SEC staff's guidance; and

- Clarifying that FINRA members may present past specific recommendations pursuant to the no-action relief currently available to registered investment advisers.

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[14] Association for Investment Management and Research, SEC No-Action Letter (pub. avail. Dec. 18, 1996).
[15] Franklin Management, Inc., SEC No-Action Letter (pub. avail. Dec. 10, 1998).

c. Investor Sophistication Standards

FINRA Rule 2210 defines an "institutional investor" to include, among other categories, persons described in Rule 4512(c). Rule 4512(c) includes a bank, savings and loan association, insurance company or registered investment company; an investment adviser registered either with the SEC under Section 203 of the Advisers Act or with a state securities commission (or any agency or office performing like functions); or any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. As several commenters noted during the rulemaking process for FINRA Rule 2210, FINRA rules, the Federal securities laws and SEC rules contain multiple inconsistent definitions intended to describe the sophistication level of prospective investors. For example, in addition to the FINRA definition of "institutional investor," an investor could qualify as a "qualified institutional buyer,"[16] qualified investor,"[17] "qualified purchaser,"[18] or "accredited investor."[19]

The multiple inconsistent standards for investor sophistication under FINRA rules, the Federal securities laws and SEC rules create unnecessary confusion, compliance challenges and operational inefficiencies for member firms. For example, a member firm marketing a Section 3(c)(7) fund may use institutional materials to market the fund to a state-registered investment adviser representing a single investor with $5 million in assets, but is required to use retail materials to market the same fund to an unregistered family office with $49 million in assets. Further, the member firm is required under the 1940 Act to ensure that potential investors meet the "qualified purchaser" standard, but must take additional steps (and maintain additional operational and supervisory procedures) to qualify potential purchasers as "institutional investors" prior to using institutional marketing materials with such persons. In light of the fact that the SEC determined that "qualified purchasers" do not require the full protections of the 1940 Act in connection with investments in Section 3(c)(7) funds (nor the full protections of the 1933 Act when interests in such funds are sold in compliance with Regulation D thereunder), the additional step of qualifying "qualified purchasers" as "institutional investors" prior to using institutional marketing materials with such persons does not appear to serve any meaningful investor protection purpose.

As FINRA has previously noted, any test of investor sophistication based on wealth may be both under-inclusive (by excluding financially sophisticated investors who do not meet the definition's wealth tests) and over-inclusive (by including wealthy financial novices).[20] We agree with FINRA's assessment that no wealth standard is a perfect proxy for investor sophistication, but we also believe that the industry as a whole would benefit from simplifying the multiple inconsistent standards that have been established. We understand that FINRA has previously

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[16] *See* Rule 144A(a)(1) under the Securities Act.

[17] *See* Exchange Act § 3(a)(54).

[18] *See* 1940 Act § 2(a)(51) and Rule 2a51-1 thereunder.

[19] *See* Securities Act § 2(a)(15).

[20] *See* File No. SR-FINRA-2011-035, Letter from Joseph P. Savage, FINRA, dated Dec. 22, 2011.

considered this issue and declined to lower the minimum asset threshold for "institutional investors" from its arbitrarily established value of $50 million to a standard used in the federal securities laws and regulations thereunder.[21] We further understand that FINRA cannot alter the definitions contained in either federal statutes or SEC rules. However, we urge FINRA to take action where it is able, and to reconsider harmonizing its definition of "institutional investor" with the "qualified purchaser" standard under the 1940 Act. Doing so will not only ensure that FINRA's definition is aligned with the SEC's highest standard for sophistication under the 1940 Act, as that standard may be amended from time to time, but will also ease a significant compliance and operational burden that has been imposed on member firms without any corresponding investor protection benefit.

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We appreciate the opportunity to submit these comments as part of FINRA's retrospective review of the Rules. Please feel free to contact Michael Caccese at 617.261.3133 or Kenneth Juster at 617.261.3296 with any questions about this submission.

Very truly yours,

K&L Gates LLP

K&L Gates LLP

[21] *Id.*