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July 17, 2024

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
Via email to rule-comments@sec.gov

Re: File No SR-FINRA-2023-016: Proposed Rule Change to Permit Projections of Performance in Institutional Communications and Specified Communications to Qualified Purchasers

Dear Ms. Countryman:

The Financial Industry Regulatory Authority, Inc. ("FINRA") submits this letter to respond to comments the Securities and Exchange Commission ("SEC" or "Commission") received on the above-referenced rule filing. The proposed rule change, as amended by Partial Amendment No. 1 ("Amended Proposal"), would amend FINRA Rule 2210 (Communications with the Public) to allow a member, when conditions are met, to project the performance or provide a targeted return with respect to a security or asset allocation or other investment strategy in: (1) an institutional communication; or (2) a communication distributed or made available only to persons meeting the definition of either "qualified purchaser" ("QP") under the Investment Company Act of 1940 ("Investment Company Act" or "ICA") or "knowledgeable employee" ("KE") under ICA Rule 3c-5, and that promotes or recommends specified non-public offerings.

The Commission published the proposed rule change for public comment in the Federal Register on November 24, 2023.[1] The Commission received ten comment letters on the proposed rule change.[2] In consideration of those comments, on February 22, 2024,

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[1] See Securities Exchange Act Release No. 98977 (November 17, 2023), 88 FR 82482 (November 24, 2023) (Notice of Filing of File No. SR-FINRA-2023-016) ("Initial Rule Filing").

[2] See Letter from Meredith Cordisco, Associate General Counsel, FINRA, to Vanessa Countryman, Secretary, SEC, dated February 22, 2024 ("Initial Response to Comments") (including, as Attachment A, an Alphabetical List of Commenters to File No. SR-FINRA-2023-016).

FINRA filed Partial Amendment No. 1 and submitted a letter responding to the comments on the Initial Rule Filing, including those that led to the Partial Amendment.[3]

On February 22, 2024, the Commission published a notice and order in the Federal Register to solicit comments on the Partial Amendment and to institute proceedings pursuant to Section 19(b)(2)(B) of the Securities Exchange Act of 1934 ("SEA") in the above-referenced rule filing to determine whether to approve or disapprove the Amended Proposal.[4] The SEC received four comment letters in response to the Order.[5]

In general, the commenters responding to the Order reiterated comments made to the Initial Rule Filing. Several commenters continued to encourage further alignment between the Amended Proposal and the SEC's Rule 206(4)-1 ("IA Marketing Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[6] Morgan Lewis stated that more closely aligning the Amended Proposal with the IA Marketing Rule's treatment of hypothetical performance would avoid "perpetuating a disjointed marketplace where products marketed through investment advisers and products marketed through broker-dealers are subject to different rules, thereby confusing investors or potentially even harming investors by needlessly reducing the universe of available information based on the channel through which it is disseminated." ICI incorporated the points raised in its initial letter, noting that its long-term policy preference is for greater alignment with the IA Marketing Rule, but expressing support for the Amended Proposal as a "welcome step." ICI also stated that the Amended Proposal would protect investors and the public interest. Monument Group reiterated its comment that broker-dealers should not be prohibited from using projections in a manner consistent with those permitted under the IA Marketing Rule, that FINRA's prohibitions on the use of hypothetical, backtested and prior performance diverge from the IA Marketing Rule and will limit the practical application of the Amended Proposal, and that FINRA's current treatment of Internal Rates of Return ("IRR") deviates from the IA Marketing Rule, which Monument Group states treats IRR as actual

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3 See Partial Amendment No. 1 to File No. SR-FINRA-2023-016 filed on February 22, 2024, https://www.finra.org/sites/default/files/2024-02/SR-FINRA-2023-016-Partial-A-1.pdf.

4 See Securities Exchange Act Release No. 99588 (February 22, 2024), 89 FR 14728 (February 28, 2024) (Order Instituting Proceedings To Determine Whether To Approve or Disapprove File No. SR-FINRA-2023-016) ("Order").

5 See Attachment A: Alphabetical List of Commenters to Order Instituting Proceedings To Determine Whether To Approve or Disapprove File No. SR-FINRA-2023-016.

6 See ICI, Monument Group, Morgan Lewis.

performance (rather than hypothetical performance) even when unrealized positions are included in the calculation.

Commenters also restated suggestions made in response to the Initial Rule Filing that FINRA should broaden the recipients for whom projections of performance and targeted returns can be used. Specifically, Morgan Lewis stated that the Amended Proposal's blanket limitation on the use of projections to institutional investors and QPs is in sharp contrast to the IA Marketing Rule, which it states does not impose a uniform investor qualification test regarding hypothetical performance in investment adviser advertising. Morgan Lewis further suggested that FINRA's Amended Proposal prohibits broker-dealers from using projections or targeted returns with certain investors where their investment adviser peers are not similarly restricted, which is unnecessarily unfair to broker-dealers and their registered representatives, issuers who market and distribute their products through brokerage channels, and to investors. Morgan Lewis stated that, if FINRA continues to feel limiting the audience for whom projections could be appropriate, FINRA should at least allow projections or targeted returns for accredited investors.[7]

One commenter repeated concerns raised in response to the Initial Rule Filing relating to the Amended Proposal's conditions for the use of projections of performance and targeted returns.[8] Specifically, Monument Group restated its position that the Amended Proposal's recordkeeping obligation associated with the requirement for the member to have a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return is unnecessary and burdensome.

FINRA has already addressed the aforementioned comments, which were previously raised in response to the Initial Rule Filing, in its Initial Response to Comments and, accordingly, incorporates those responses here. Nonetheless, FINRA would like to elaborate on several of those responses.

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7 See 17 CFR 230.501(a) (defining "accredited investor" for purposes of Securities Act Regulation D, 17 CFR 230.500-508, to include, among other categories, any natural person whose individual net worth, or joint net worth with that person's spouse or spousal equivalent, exceeds $1,000,000, and any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse or spousal equivalent in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year).

8 See Monument Group.

Reasonable Basis Requirement

The Amended Proposal would require a member to have a reasonable basis for a projection of performance or targeted return. Several commenters addressed the reasonable basis requirement in comment letters in response to the Initial Rule Filing and to the Order.[9] FINRA would like to provide additional clarifications to supplement the Initial Response to Comments.

First, in addition to the longstanding FINRA precedents for a reasonable basis standard for projections of performance,[10] FINRA emphasizes the foundational importance of ensuring that a member has a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return. Without forming a reasonable basis, a member's projections of performance and targeted returns could be based on guesswork, dubious presumptions, and wildly inaccurate or inherently misleading reasoning. Requiring a reasonable basis ensures that the member acts with reasonable diligence and good faith.

Second, as noted in the Initial Response to Comments, some commenters suggested that the reasonable basis requirement, the factors in the proposed Supplementary Material, and the associated recordkeeping requirements would be burdensome and onerous.[11] As stated above, Monument Group suggested that the non-exhaustive list of factors that members should consider in developing a reasonable basis set forth in the Supplementary Material may create potentially overlapping, ambiguous and onerous requirements that could dissuade members from using performance projections and targets with investors. Monument Group further asserted that the requirement to retain written records supporting a member's reasonable basis for the projection or targeted return would require the member to access and retain materials that fund managers would consider trade secrets.

As explained in the Initial Rule Filing, FINRA intends for members to consider multiple factors, with no one factor being determinative. In that vein, FINRA notes that the proposed Supplementary Material's factors are meant to be a helpful guide for firms, and we recognize that not all factors may be relevant to a particular projection of performance or targeted return. In addition, there is no requirement to obtain trade secrets from third parties. Members must, however, consider information that is available to determine whether there is a reasonable basis for the projection or targeted return. This standard is intended to be flexible; however, if a member is unable to make that determination based

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9 See Initial Response to Comment at 8-11; Monument Group.

10 See Initial Rule Filing, 88 FR 82482, 82484.

11 See Initial Response to Comment at 9.

on available information, the member must consider whether it can include projections or targeted returns in its communications consistent with this standard.

Moreover, we will monitor developments and issue further guidance, if appropriate, once FINRA and members have experience with these factors over time.

Projections of Performance and Targeted Returns – Scope of Application

In addition to some commenters' suggestion that the Amended Proposal allow the use of projections of performance or targeted returns in communications to a broader range of investors generally, as noted in the Initial Response to Comments, some commenters to the Initial Rule Filing suggested that, with respect to QPs, the proposal should be "product agnostic."[12] In this vein, SIFMA recommended "allowing QPs in funds that are exempt from registration under ICA Sections 3(c)(1) and 3(c)(5) (and other non-3(c)(7) funds) to receive projected performance and targeted returns even where those funds are available to non-QPs."

FINRA's Initial Response to Comments explained that both "qualified purchaser" and "knowledgeable employee" are defined by reference to private funds that rely on ICA Section 3(c)(7) to avoid registration under the ICA. FINRA noted that we purposely had chosen to tie the exception for communications containing projections or targeted returns to specified private placement exemptions contained in Rules 5122 and 5123.[13] FINRA previously determined that these exemptions appropriately excluded these private offerings from additional review under those rules.

At the time FINRA adopted Rule 5123, for example, FINRA explained that most funds structured pursuant to ICA Section 3(c)(1) are designed to be offered and sold to accredited investors or qualified clients,[14] and we noted that we were not persuaded at that

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12 See ABA, ICI, SIFMA. See also Initial Response to Comments at 8.

13 See Rule 5122(c)(1)(B) and Rule 5123(b)(1)(B) (exempting from those rules' requirements private offerings sold solely to QPs, as defined in Section 2(a)(51)(A) of the ICA); and Rule 5123(b)(1)(H) (exempting knowledgeable employees as defined in ICA Rule 3c-5).

14 See 17 CFR 275.205-3 (defining "qualified client" to include, among other categories, an investment adviser client who is a qualified purchaser as defined in Section 2(a)(51)(A) of the ICA, and clients that meet specified assets under management and net worth thresholds (currently, at least $1 million in assets under management or net worth of more than $2.1 million)). See also Advisers Act Release No. 5756 (June 17, 2021), 86 FR 32993 (June 23, 2021), (Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940).

time that the accredited investor standard warranted an exemption from the filing requirements of the then-proposed rule because we believed that the accredited investor standard did not require a sufficient level of sophistication to justify an exemption.[15] In addition, in its experience, FINRA staff has found that some private placements relying on Regulation D have been sold to investors that met the "accredited investor" standard but did not possess investment sophistication.[16]

As we noted in our Initial Response to Comments, we are similarly unpersuaded here that the Amended Proposal should allow broker-dealers to use projections in communications to QPs and KEs that relate to offerings available to accredited or other retail investors, such as private funds that rely on ICA Sections 3(c)(1) or 3(c)(5), who may not have the same level of sophistication as institutional investors, QPs and KEs.[17]

As the SEC staff noted in its December 2023 review of the accredited investor definition in Securities Act Regulation D, the number and percentage of U.S. households qualifying for accredited investor status has grown from 1.51 million, or 1.8% of all U.S. households, in 1983, when Regulation D was adopted, to 24.3 million households, or 18.5% of all U.S. households, in 2022.[18] Given that the accredited investor standard was

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15 See FINRA's Response to Comments to File No. SR-FINRA-2011-057 (regarding the proposed rule change to adopt FINRA Rule 5123 (Private Placements of Securities)), available at https://www.finra.org/sites/default/files/RuleFiling/p125430.pdf.

16 See, e.g., Department of Enforcement v. Red River Securities, LLC and Brian Keith Hardwick, FINRA Office of Hearing Officers Extended Hearing Panel Decision (February 9, 2017) at 45.

17 As discussed, the Amended Proposal would limit the use of projections to: (1) an institutional communication; or (2) a communication distributed or made available only to persons meeting the definition of either QPs or KEs and that promote or recommend private offerings that are sold solely to QPs and KEs. With respect to the latter category, as SIFMA noted, funds relying on ICA Sections 3(c)(1) or 3(c)(5) are offered and sold to a wider range of investors who are neither QPs nor KEs. Thus, a member would not be able to use a projected performance or targeted returns in any communications to QPs or KEs related to such offerings that are available to a wider range of investors. See Initial Response to Comments, n.30. While it is theoretically possible that a broker-dealer may sell shares of a non-public offering that relies on sections 3(c)(1) or 3(c)(5) only to QPs and KEs, FINRA believes this scenario is highly unlikely, since the purpose of those exemptions is to allow sales to a wider range of investors.

18 See Review of the 'Accredited Investor' Definition under the Dodd-Frank Act, report by the staff of the U.S. Securities and Exchange Commission (December 14,

first used as a proxy for financial sophistication in 1983, and has not changed since that year, it seems highly unlikely that the percentage of financially sophisticated U.S. households has likewise grown from 1.8% to 18.5% of all U.S. households. In fact, the SEC staff concluded that "with the increased use of the private markets and expansion of the number of persons that may be considered accredited investors, it is possible that some accredited investors may not be able to negotiate access to information from issuers under Rule 506 offerings, and therefore these investors may not receive the information they need to make informed investment decisions."[19]

In addition, by limiting the use of projections of performance or targeted returns to QPs and KEs in communications that relate to offerings that are sold solely to these types of sophisticated investors, we may be limiting the risk that communications that contain projections or targeted returns would be provided erroneously to less sophisticated investors, including retail investors, in contravention of the rule.

Accordingly, based on the SEC staff's review of the accredited investor definition, our experience with members' communications with the public, Rules 2210, 5122 and 5123, and the long-standing categories established by those rules, FINRA believes that the Amended Proposal's limitations on the use of projections of performance or targeted returns to: (1) institutional communications; and (2) communications distributed or made available only to QPs or KEs and that promote or recommend specified non-public offerings, are the appropriate categories for an exception to the general prohibition on the use of projected performance or targeted returns. The Amended Proposal represents an incremental and narrowly tailored approach to allowing the use of projections of performance or targeted returns. FINRA will reassess whether these proposed categories and product limitations are appropriate once FINRA has sufficient experience with the rule change.

Policies and Procedures Requirement

In its latest comment letter, Monument Group reiterated its comment that the Amended Proposal's requirement to have policies and procedures reasonably designed to ensure that communications containing projections and targeted returns are relevant to the financial situation and investment objectives of the recipient are redundant with, and impose additional requirements than, suitability obligations. Monument Group also suggested that the Amended Proposal will require broker-dealers to collect additional information from institutional investors about their financial objectives and situation.[20] As

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2023), at 23, https://www.sec.gov/files/review-definition-accredited-investor-2023.pdf.

19 Id. at 44.

20 See Monument Group at n.2.

noted in the Initial Response to Comments, ABA requested that, if FINRA adopted the proposal, FINRA provide guidance for broker-dealers "in circumstances where they determine that projections or targeted returns are appropriate for some potential investors in the prescribed nonpublic offerings, but not others, including whether broker-dealers should limit the use of projection and targeted return information to prospective fund investors who pass the independent suitability requirements of Rule 2111 and Regulation Best Interest."[21]

As noted in the Initial Response to Comments, FINRA Rules 2210 and 2111 (Suitability) are distinct rules with different scopes and objectives. Rule 2111 and the SEC's Regulation Best Interest[22] require a broker-dealer to consider an investor's investment profile (including, among other factors, investment objectives), and these requirements apply when the broker-dealer is making a recommendation (as interpreted for purposes of those rules) of a security or investment strategy involving a security. Rule 2210 is broader and governs any communications that a member distributes or makes available to investors, regardless of whether the communications contain a recommendation that would also trigger obligations under Rule 2111 or Regulation Best Interest.

The Amended Proposal would require a member to adopt and implement written policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication. The term "likely" indicates that a member is not required to know the actual financial situation or investment objectives of each investor that receives the communication. Members are permitted to comply with this condition by grouping investors into categories or types, which should alleviate the commenter's concern regarding the collection of information for individual institutional investors.[23] Moreover,

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21 See ABA at 4-5; Initial Response to Comments at 12.

22 17 CFR 240.15*l*-1.

23 FINRA notes that the IA Marketing Rule similarly requires investment advisers that present hypothetical performance in an advertisement to adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the intended audience of the advertisement. See 17 CFR 275.206(4)-1(d)(6)(i). The SEC stated in its adopting release for the IA Marketing Rule that these policies and procedures "need not address each recipient's particular circumstances; rather, the adviser must make a reasonable judgement about the likely investment objectives and financial situation of the advertisement's intended audience. . . . [A]dvisers can comply with this condition, as well as the other conditions related to hypothetical performance, by grouping individuals into categories or types, and to emphasize

FINRA's Amended Proposal does not have an express document or data collection requirement and would not require firms to assess individual investors under a suitability or Regulation Best Interest standard when determining whether the communication is relevant to the likely financial situation and the investment objectives of the investor receiving the communication.

As noted in the Initial Response to Comments, several commenters suggested that the requirement to have reasonably designed policies and procedures to ensure the communication is relevant to the likely financial situation and investment objectives of the investors is unnecessary because, unlike the IA Marketing Rule, the Amended Proposal already expressly limits the use of projections of performance or targeted returns to communications to certain sophisticated investors.[24] As noted in the Initial Response to Comments, we believe that this requirement, which incorporates a similar requirement in the IA Marketing Rule for the use of hypothetical performance, is important because it will encourage the member firm to focus on the intended audience for the communication, beyond simply the threshold limitations discussed above.

Time Horizon

In its comment letter to the Initial Rule Filing, SIFMA asked FINRA to confirm that members may use projections relevant to the time horizon of the investment. As noted in our Initial Response to Comments, this determination will always depend on the facts and circumstances of the projection or targeted return, which may or may not be consistent with an investment's time horizon, or in the case of a debt security, its maturity date. Moreover, an investment's time horizon often is uncertain at the time a security is issued and may change due to subsequent events. Further, a time horizon could be of such a length that it would be unreasonable to project performance for the equivalent of that time period. Accordingly, given that any projection or targeted return must have a reasonable basis, FINRA does not agree that there should be an exception from this requirement based solely on an investment's estimated time horizon.

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that an investor might not be a natural person." See Investment Adviser Marketing, Advisers Act Release No. 5653 (December 22, 2020), 86 FR 13024, 13083 (March 5, 2021) ("IA Marketing Rule Adopting Release"). The Amended Proposal likewise would not require members to address each recipient's particular circumstances. Members would have to make a reasonable judgment about the likely investment objectives and financial situation of the intended audience of a communication containing a projection of performance or a targeted return, and could comply with this requirement by grouping investors into categories or types.

[24] See Initial Response to Comments at 11-12; ABA, Dechert.

Backtested Performance

Proposed Supplementary Material 2210.01(b) would prohibit members from basing projected performance or a targeted return upon (i) hypothetical, backtested performance or (ii) the prior performance of a portfolio or model that was created solely for the purpose of establishing a track record. As noted in the Initial Response to Comments, Monument Group and Dechert suggested that FINRA allow those types of performance as the basis for projected performance or targeted returns.

FINRA continues to believe that both backtested performance and prior performance of a portfolio or model created solely for the purpose of establishing a track record are not sound bases for creating a projection of performance or targeted return. For example, a 2012 Vanguard study reviewed exchange-traded funds ("ETFs") that employed backtested performance to create securities indexes that the ETFs tracked. The authors found that 87% of the funds they studied tracked indexes whose backtested performance outperformed the broad U.S. stock market. However, after the ETF indexes were launched, only 51% of these indexes outperformed the broader market – essentially a coin flip.[25]

Likewise, a 2007 study of mutual funds that initiated so-called "incubator" funds to create a pre-inception performance record typically closed incubator funds with poor records and only brought forward those with positive returns. This "survivorship bias" tended to cast doubts on the utility of using incubator fund performance as a proxy of future performance.[26]

Extracted Performance

As noted in the Initial Response to Comments, Dechert suggested that FINRA's current FAQs that prohibit the presentation of: (i) the return of any unrealized holding (as a prohibited projection); and (ii) the aggregate performance of all realized holdings in an investment program that also has unrealized holdings (as misleading) are inconsistent with the SEC IA Marketing Rule.[27] Dechert urged FINRA to withdraw these FAQs based on its belief that the FAQs are also inconsistent with the SEC's Private Fund Adviser Rules.

We decline to withdraw these FAQs for two reasons. First, the Amended Proposal does not address extracted performance, and thus Dechert's objections to the FAQs seem to be peripheral to the Amended Proposal's content. Second, as discussed below, given the

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25 See Joel M. Dickson, Sachin Padmawar & Sarah Hammer, Joined at the hip: ETF and index development, Vanguard research (July 2012) at 6.

26 See Carl Ackerman & Tim Loughran, Mutual Fund Incubation and the Role of the Securities and Exchange Commission, 70 Journal of Business Ethics 33-37 (2007).

27 See Dechert (citing FINRA FAQs D.6.2 and D.6.3).

recent decision by the United States Court of Appeals for the Fifth Circuit to vacate the SEC's Private Fund Advisers rules,[28] Dechert's concern with inconsistency with these rules appears to be moot, at least at this stage.

Newly Raised Issues

Some comments to the Order raised new issues. The Center for American Progress (CAP) expressed opposition to the Amended Proposal and raised a number of concerns. Specifically, CAP stated that the Amended Proposal lacks sufficient basis or need for the rule change. FINRA disagrees. FINRA believes the Amended Proposal will benefit investors. In addition, FINRA's regular engagement with the industry and the public and its experience with the rules, as well as the SEC's recent adoption of similar standards for IAs, sufficiently demonstrate the need and justify the basis for the Amended Proposal.

FINRA anticipates that the Amended Proposal will benefit investors without sacrificing investor protection, similar to the benefits that the Commission outlined in its adoption of the IA Marketing Rule related to investment advisers' presentation of hypothetical performance.[29] As noted in the Initial Rule Filing, broker-dealers are generally prohibited from using projections of performance and targeted returns in their communications. FINRA's Amended Proposal would allow broker-dealers to use projections of performance and targeted returns under narrow circumstances and only when the safeguarding conditions are met.

Investors also may benefit from the additional information when presented in a context that helps investors to better understand the information. In this regard, the Amended Proposal requires the member to provide sufficient information for the investor to understand (i) the criteria used and assumptions made in calculating the projected performance or targeted return, including whether the projected performance or targeted return is net of anticipated fees and expenses; and (ii) the risks and limitations of using the projected performance or targeted return in making investment decisions, including reasons why the projected performance or targeted return might differ from actual performance. These benefits will accrue without sacrificing investor protection. Broker-dealers would only be permitted to use projections of performance or targeted returns in communications to limited categories of investors who have access to the resources to independently analyze this information or who have the financial expertise to understand the risks and limitations of such performance or returns (institutional investors; and QPs and KEs when

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28 See Nat'l Ass'n of Priv. Fund Managers v. SEC, No. 23-60471, 2024 U.S. App. LEXIS 13645 (5th Cir. June 5, 2024).

29 See IA Marketing Rule Adopting Release, 86 FR 13024, 13112 (discussing the benefits of IAs' use of hypothetical performance in investment adviser advertising).

the communication recommends specified non-public offerings) and, even there, only when they meet all other conditions.

Although the Amended Proposal is not completely congruent with the related provisions of the IA Marketing Rule, it would nevertheless be beneficial in furthering regulatory harmonization.[30] Commenters have repeatedly raised concerns about the disparate treatment of broker-dealers and investment advisers in this regard. For example, in 2014, FINRA conducted a retrospective review – a comprehensive review whereby FINRA looks back at its significant rulemakings to determine whether a FINRA rule or rule set is meeting its intended investor protection objectives by reasonably efficient means, particularly in light of environmental, industry and market changes – of the communications with the public rules.[31] As part of the review, FINRA broadly solicited comment on all aspects of the communications rules.[32] In response, commenters noted that the regulatory standards differ for broker-dealers and investment advisers when communicating or providing investment advice about securities and that firms and investors would benefit from harmonization of these standards, particularly in the area of projections, performance and testimonials.[33] Forty-five percent of firms with representatives who are also registered with an investment adviser that responded to the survey stated that investment adviser and broker-dealer standards were not consistent with respect to these rules and should be harmonized.[34] As discussed more fully in the Initial Rule Filing, in 2017, based on the feedback of the retrospective rule review and FINRA's experience with the rules, FINRA solicited comment on proposed amendments to Rule

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30 For example, as discussed fully in the Initial Rule Filing and in comments, the Amended Proposal would limit, as a threshold matter, the use of projections to certain categories of sophisticated investors. In addition, the Amended Proposal would expressly require that firms have a reasonable basis for projections and targeted returns, provide factors for determining that reasonable basis, and require firms to document such reasonable basis. See also Initial Rule Filing, 88 FR 82482, 82487 (comparing FINRA's proposal to the IA Marketing Rule's treatment of hypothetical performance).

31 These retrospective reviews look at the substance and application of a rule or rule set, including any gaps or unintended consequences, as well as FINRA's processes to administer the rules. See FINRA's Retrospective Rule Review page, available at https://www.finra.org/rules-guidance/rulemaking-process/retrospective-rule-review.

32 See Regulatory Notice 14-14 (April 2014).

33 See Retrospective Rule Review Report (Communications with the Public) (December 2014) at 4 ("Retrospective Rule Review Report"), https://www.finra.org/sites/default/files/p602011.pdf.

34 See Retrospective Rule Review Report at 9.

2210 that would have created a limited exception to the rule's prohibition on projecting performance.[35] Commenters to Regulatory Notice 17-06 repeated the concerns with regulatory inconsistencies, noting that that proposal would have lessened the regulatory inconsistencies regarding the use of performance projections between broker-dealers and stand-alone investment advisers and would have reduced the opportunities for regulatory arbitrage.[36]

Since the time of the retrospective review and the 2017 proposal, the SEC adopted its IA Marketing Rule, which permits the presentation of performance, including hypothetical targeted or projected performance returns, in investment adviser advertisements, provided that the adviser meets specified conditions and does not violate the IA Marketing Rule's other requirements.[37] As discussed more fully in the Initial Rule Filing, the Amended Proposal incorporates much of the rule text in the IA Marketing Rule's provisions permitting the presentation of hypothetical performance, but with additional restrictions and requirements.[38] Although commenters in this rulemaking continue to advocate for greater regulatory harmony between the Amended Proposal and the IA Marketing Rule's treatment of hypothetical performance, as discussed above and in the Initial Response to Comments, the Amended Proposal is nevertheless a step towards regulatory harmonization. We will continue to monitor and consider whether further harmonization is appropriate.

Feedback through FINRA's regular engagement with the industry and the public supports the Amended Proposal. One area that received frequent comment during FINRA's retrospective review of the communications with the public rules was the restrictions on projections of performance.[39] We noted that, "[m]any stakeholders favored more permissive use of predictions or projections and alternative performance standards (*e.g.*, hypothetical and back-tested performance, related performance, model performance and targeted returns) and greater clarity with respect to the current requirements."[40] Subsequently, commenters to Regulatory Notice 17-06 again discussed the benefits of using projections of performance or targeted returns in communications, with appropriate

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35 See Regulatory Notice 17-06 (February 2017). See also Initial Rule Filing, 88 FR 82482, 82490.

36 See Initial Rule Filing, 88 FR 82482, 82490-91 (summarizing comments received in response to Regulatory Notice 17-06).

37 See IA Marketing Rule Adopting Release.

38 See supra note 30.

39 See Retrospective Rule Review Report.

40 Id. at 3.

protections. Notably, commenters stated that institutional investors often seek this information, and receive it through other channels (including issuers and investment advisers) with less onerous burdens on their communications.[41]

Since that time, FINRA has repeatedly heard similar feedback, including from practitioners and through its advisory and ad hoc committees,[42] such as the Public Communications Committee. Through this engagement, FINRA understands that institutional investors and QPs often test their own opinions against performance projections they receive from other sources, including from issuers and investment advisers. This feedback, as well as our experience with the rule, suggests that current prohibition on broker-dealers using projections of performance or targeted returns in any manner creates an incentive for issuers to avoid the registered broker-dealer channel to offer securities and instead either use an unregistered firm, or market securities directly to potential investors.[43] The Amended Proposal would allow members to provide information regarding projected performance or targeted returns akin to that investors are already receiving from issuers or other unregistered intermediaries, but subject to substantial requirements that enhance investor protections.

CAP also suggested that, by allowing broker-dealers to use projections of performance and targeted returns, when conditions are met, in communications to specified categories of persons that have been previously determined to be financially sophisticated or able to engage expertise for purposes of understanding the risks and limitations of using projected performance, FINRA "inaccurately narrows the purported value of Rule 2210," and thereby puts these sophisticated investors at risk of being misled by "cherry-picked or inaccurate information and dubious projections or predictions." FINRA strongly disagrees with any suggestion that the Amended Proposal "effectively abandon[s] its decades-long protection against misleading performance predictions and projections."

Indeed, FINRA emphasizes that projections of performance or targeted returns that are misleading or lack a sound basis will continue to be prohibited under the Amended Proposal. As noted in the Initial Rule Filing, institutional communications and QP private placement communications that contain projected performance or targeted returns must meet Rule 2210's general standards, including the requirements that communications be fair and balanced, provide a sound basis for evaluating the facts in regard to any particular

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41 See Initial Rule Filing, 88 FR 82482, 82490-94.

42 For more information on FINRA's advisory and ad hoc committees, see https://www.finra.org/about/governance/advisory-committees and https://www.finra.org/about/governance/ad-hoc-committees.

43 See Initial Rule Filing, 88 FR 82482, 82488 n.47 (noting that the majority of private offerings governed by Securities Act Regulation D are sold directly by issuers without any broker-dealer involvement).

security or type of security, and not contain false, exaggerated, unwarranted, promissory or misleading content.[44] Accordingly, any communication containing a projection or targeted return would be prohibited from presenting exaggerated or unwarranted projections or targeted returns. Moreover, as discussed in the Initial Rule Filing, as a condition to using a projected performance or targeted return in communications to these limited categories of persons, a member would need to ensure that there is a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return. The Supplementary Material sets forth strong factors for making that reasonable determination, and the firms would be required to document and retain written records supporting the basis for such criteria and assumptions.

The Amended Proposal would allow the use of projections of performance or targeted returns in institutional communications, or in a communication that is distributed or made available only to QPs or KEs and that promotes or recommends specified non-public offerings. CAP argues that investors and market participants do not have information they need to determine the value of unregistered securities, that such information may be unreliable, and that it would be difficult, if not impossible, to offer projections that are not materially misleading. FINRA disagrees.

Congress has determined that, in some circumstances, the general requirement in the Securities Act of 1933 that every offer and sale of securities be registered with the SEC and the attendant required disclosures are not necessary.[45] It is not FINRA's position to comment on or second guess the statutory exemptions from registration, and those established by the Commission's rules and regulations. Under the Amended Proposal, a broker-dealer must form a reasonable basis for the criteria used and assumptions made in calculating a projected performance or targeted return. If a broker-dealer is not satisfied that it can form a reasonable basis with respect to projections of performance or targeted return because of what it perceives as unreliable or unsubstantiated information on the issuer, then the broker-dealer would not be able to comply with the conditions of the rule, and the use of such projections of performance or targeted returns in those circumstances would be prohibited. Nevertheless, FINRA notes that private securities offerings, which are subject to the antifraud provisions of the federal securities laws, typically do provide

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44 See FINRA Rule 2210(d)(1)(A) and (B).

45 H.R. Rep. No. 73-85, at 5 (1933).

disclosures,[46] and there are generally accepted methods to assess private company valuations[47] and forecasts.[48]

Finally, CAP states that the Amended Proposal ignores the logic of the SEC's recently adopted Private Fund Advisers rules and contravenes the purpose.[49] As noted above, the United States Court of Appeals for the Fifth Circuit recently ruled to vacate the SEC's Private Fund Advisers rules.[50] In any event, FINRA disagrees with CAP's comment, as the Amended Proposal is intended to serve a different purpose than the stated purpose of the Private Fund Advisers rules. The Amended Proposal will provide investor protection safeguards where projections of performance or targeted returns are used with specified sophisticated investors. In contrast, the SEC indicated that the Private Fund Advisers rules were adopted to enhance private fund adviser regulation and "protect investors who directly or indirectly invest in private funds by increasing visibility into certain practices involving compensation schemes, sales practices, and conflicts of interest through disclosure; establishing requirements to address such practices that have the potential to lead to investor harm; and restricting practices that are contrary to the public interest and the protection of investors."[51] Given these divergent purposes, FINRA does not believe the Amended Proposal contravenes the Private Fund Advisers rules' objectives.

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46 See, e.g., Andrew N. Vollmer, Evidence of the Use of Disclosure Documents in Private Securities Offerings to Accredited Investors, Mercatus Working Paper, Mercatus Center at George Mason University (October 2020) (discussing the prevalence of disclosures in private offerings and concluding that issuers "overwhelmingly" made disclosures of critical information in private offering transactions notwithstanding the absence of a legal obligation to do so).

47 See, e.g., CFA Institute, Private Company Valuation, available at https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/private-company-valuation.

48 See, e.g., CFA Institute, Company Analysis, Forecasting, available at https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/Company-Analysis-Forecasting.

49 See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 6383 (August 23, 2023), 88 FR 63206 (September 14, 2023) ("Private Fund Advisers Rules Adopting Release").

50 See supra note 28.

51 See Private Fund Advisers Rules Adopting Release, 88 FR at 63206.

FINRA believes that the foregoing responds to the material issues raised by the commenters to the rule filing and has determined not to further amend the Amended Proposal in response to comments. If you have any questions, please contact me at (202) 728-8018, email: meredith.cordisco@finra.org.

Best regards,

/s/ Meredith Cordisco

Meredith Cordisco
Associate General Counsel
Office of General Counsel

Attachment A: Alphabetical List of Commenters to Order Instituting Proceedings To Determine Whether To Approve or Disapprove File No. SR-FINRA-2023-016

1. Molly M. Diggins, Monument Group, Inc. ("Monument Group") (March 29, 2024)

2. Dorothy M. Donohue & Matthew Thornton, Investment Company Institute ("ICI") (March 15, 2024)

3. Jack O'Brien, Morgan, Lewis & Bockius LLP ("Morgan Lewis") (March 25, 2024)

4. Alexandra Thornton, Center for American Progress ("CAP") (April 12, 2024)