



## SEC Adopts New FINRA Rule Governing Communications with the Public

The Securities and Exchange Commission (the “SEC”) has approved the proposed new rules of the Financial Industry Regulatory Authority, Inc. (“FINRA”) governing communications by member firms with the public. The new rules will become effective on February 4, 2013.<sup>1</sup>

The Communication Rules adopt the National Association of Securities Dealers, Inc. (“NASD”) Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-3 through 2210-8 as FINRA Rules 2210 and 2212 through 2216 (collectively, the “Communication Rules”), and delete certain provisions of Incorporated New York Stock Exchange (“NYSE”) Rule 472 (as well as certain supplementary material and interpretations related to this rule). These rules govern FINRA member firms’ communications with the public.

The NASD Rules being adopted generally govern all FINRA member firms’ communications with the public. NYSE Rule 472 governs these communications by firms that are also members of the NYSE.

The following is a brief summary of some of the most significant changes to the current rules governing communications with the public.

### Communication Categories

Current NASD Rule 2210 divides communications into six categories and applies different pre-approval, filing and content standards to each. The current categories are “advertisement,” “sales literature,” “correspondence,” “institutional sales material,” independently prepared reprint” and “public appearance.” The rule change reduces the number of communication categories from six to three. The new categories are:

- *Institutional communication*: this includes written (including electronic) communications that are distributed or made available only to institutional investors, but does not include a firm’s internal communications. The new rule adopts the former definition of “institutional investor” from NASD Rule 2211 and includes registered investment companies, insurance companies, banks, registered broker-dealers, registered investment advisers, certain retirement plans, governmental entities, and individual investors and other entities with at least \$50 million in assets.
- *Retail communication*: this includes 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”

<sup>1</sup> FINRA Regulatory Notice 12-29, announcing the final rules, can be found at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p127014.pdf> (hereinafter, the “FINRA Notice”).

includes any person other than an institutional investor, regardless of whether the person has an account with the firm.

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

## Correspondence and Retail Communications

Note that any written communication, if distributed to 25 or fewer retail investors during any 30-day period, is considered correspondence. On the other hand, any such communication distributed to more than 25 retail investors in any 30-day period is a retail communication. The number of recipients, therefore, will determine the pre-approval, filing and content standards applicable to the communication.

### “Reason to Believe” Standard

FINRA Rule 2210(a)(4) provides that members may not treat communications as institutional communications if they have “reason to believe” that the communication (or any excerpt) will be forwarded to any retail investor. The rule does not impose any affirmative obligation on firms to inquire whether an institutional communication is being forwarded, or make a member firm responsible for supervising those associated with a recipient broker-dealer. However, firms should have policies and procedures designed to prevent forwarding, such as the use of legends, and appropriate training and guidance for their personnel.

If a firm becomes aware that a recipient institutional investor is forwarding communications to retail investors, the firm must treat future communications with that institutional investor as retail communications until it reasonably concludes the forwarding practice has ceased.

## Principal Pre-Use Approval Requirements for Retail Communications

FINRA Rule 2210(b)(1)(A) requires an appropriately qualified registered principal of the firm to approve each retail communication before the earlier of its use or filing with FINRA. A Series 16 supervisory analyst approved pursuant to Incorporated NYSE Rule 344 is permitted to approve research reports on debt and equity securities, as well as retail communications that, while research-related, are not “research reports” as defined in NASD Rule 2711, provided the supervisory analyst has technical expertise in the applicable product area and has the requisite registration (e.g., the separate registration required for options or futures professionals).<sup>2</sup>

FINRA Rule 2210(b)(1)(C) preserves the current exception from principal pre-use review for retail communications if, at the time that a firm intends to publish or distribute it, (i) another firm has filed it with FINRA and has received a letter from FINRA stating that it appears to be consistent with applicable standards and (ii) the firm using the communication in reliance on this exception has not materially altered it and will not use it in a manner that is inconsistent with the conditions of the Advertising Regulation Department’s letter.

FINRA Rule 2210(b)(1)(D) excepts from the principal pre-use approval requirements three additional categories of retail communications, provided that the firm supervises and reviews the communications. These include:

- any retail communication that is excepted from the definition of “research report” under NASD Rule 2711(a)(9)(A), unless the communication makes any financial or investment recommendation;
- any retail communication that is posted on an online interactive electronic forum; and

<sup>2</sup> See, Supra Note 1, FINRA Notice, at 7.

- any retail communication that does not make any financial or investment recommendation or otherwise promote a product or service of the firm.

FINRA Rule 2210(b)(1)(E) allows FINRA to grant an exemption from the principal pre-use approval requirements for good cause shown after taking into consideration all relevant factors, provided that the exemption is consistent with the purposes of FINRA Rule 2210, the protection of investors and the public interest. FINRA has stated that it intends to employ this exemptive authority only in unique circumstances and on a case-by-case basis.<sup>3</sup>

## **Supervisory and Review Requirements for Correspondence and Institutional Sales Material**

FINRA Rules 2210(b)(2) and (3) generally maintain the supervision and review standards for correspondence and institutional communications that are currently found in NASD Rules 2211 and 3010(d).

## **Recordkeeping Requirements**

FINRA Rule 2210(b)(4)(A) sets forth the recordkeeping requirements for retail and institutional communications, and generally leaves in place the current recordkeeping requirements contained in NASD 2210(b)(2). This provision incorporates by reference the recordkeeping format, medium and retention period requirements of Rule 17a-4 under the Securities Exchange Act of 1934, as amended. The records must include:

- a copy of the communication and the dates of first and (if applicable) last use;
- the name of any registered principal who approved the communication and the date that approval was given;
- in the case of a communication that is not approved prior to first use by a registered principal, the name of the person who prepared or distributed the communication;
- information concerning the source of any statistical table, chart, graph or other illustration used in the communication; and
- for retail communications that rely on the exception for materials previously filed by another firm, the name of the firm that filed the retail communication with FINRA and a copy of the Advertising Regulation Department's review letter.

## **Filing Requirements and Review Procedures**

### **New Member Firms**

FINRA Rule 2210(c)(1)(A) requires a new member firm to file its initial advertisement with the Advertising Regulation Department at least ten days prior to its first use. This obligation continues until one year following the effective date of the firm's membership. To the extent any retail communication is a free writing prospectus required to be filed with the SEC, the firm may file it within ten days of first use, rather than ten days prior to first use.

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<sup>3</sup> See, Supra Note 1, FINRA Notice, at 8.

## Firms that Depart from FINRA Standards

Under the new Rules, FINRA has maintained the prior authority of the Advertising Regulation Department to require a firm to file all of the firm's communications if it determines that the firm has departed from FINRA standards.

## Pre-Use Filing Requirements

All member firms are required to file certain communications at least ten days prior to first use, including retail communications (i) concerning any registered investment company that include self-created rankings, (ii) concerning security futures or (iii) that include bond mutual fund volatility ratings.

## Concurrent with Use Requirements

FINRA Rule 2210(c)(3) requires the following to be filed within ten days of first use:

- retail communications concerning registered investment companies and public direct participation programs;
- all retail communications concerning closed-end registered investment companies;
- retail communications concerning closed-end funds that are distributed during *or after* the fund's initial public offering (IPO) period;
- all advertisements and sales literature concerning continuously offered (interval) closed-end funds;
- templates for written reports produced by, or retail communications concerning, an investment analysis tool, as that term is defined in FINRA Rule 2214;
- retail communications concerning CMOs that are registered under the Securities Act of 1933;
- retail communications concerning any security that is registered under the Securities Act of 1933 and that is derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency (i.e., structured notes); and
- if a firm has filed a draft version or "story board" of a television or video advertisement pursuant to a filing requirement, the final filmed version.

Generally consistent with current rules, the member firm must provide with each filing the actual or anticipated date of first use, the name, title and CRD number of the registered principal who approved the advertisement or sales literature and the date that the approval was given. Each firm's written and electronic communications may be subject to a spot-check procedure, and that firms must submit requested material within the time frame specified by the Advertising Regulation Department.

## Exclusions from Filing Requirements

The new FINRA rules generally duplicate the prior exclusions from the filing requirements, including exclusions for:

- material that has been filed previously or based on templates filed previously;

- materials related only to recruitment or firm name change or similar updates;
- material that does no more than identify a national securities exchange symbol for the firm or identify a security for which the firm is a registered market maker;
- material that does no more than identify the firm or offer a specific security at a stated price;
- certain “tombstone advertisements;”
- reprints of independently prepared articles;
- prospectuses filed with the SEC;
- material that refers to types of investments solely as part of a listing of products or services offered by the firm;
- communications that are posted on online interactive electronic forums; and
- press releases issued by closed-end investment companies listed on the NYSE that are subject to the NYSE’s “immediate release policy.”

## Content Standards

FINRA Rule 2210(d)(1)(A) incorporates the basic content standards from the prior rule without change. Firm communications must be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service. Firms may not omit any material fact or qualification if the omissions, in light of the context of the material presented, would cause the communication to be misleading.

A firm may not make any false, exaggerated, unwarranted or misleading statement or claim in any communication, may not publish, circulate or distribute any communication that the firm knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading and may not make any promissory statements or claims.

Information may be placed in a legend or footnote only in the event that the placement would not inhibit an investor’s understanding of the communication.

Firms must ensure that statements are not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. It also requires communications to be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent in investments. Firms must consider the nature of the audience to which a communication will be directed and to provide details and explanations appropriate to the audience.

The new rules carry over the current prohibition on communications that predict or project performance, while permitting a hypothetical illustration of mathematical principles, provided that the illustration does not predict or project the performance of an investment or investment strategy, but FINRA has now clarified two additional types of projections of performance are permitted. First, FINRA allows projections of performance in reports produced by investment analyst tools that meet the requirements of NASD IM-2210-6. Second, FINRA has permitted research reports on debt or equity securities to include price targets under certain circumstances.

The new rules also carry forward the prior guidance and required disclosures concerning references to tax-free or tax exempt income, as well as tax deferral, as well as the disclosure of fund sales charges and operating expense ratios.

## Recommendations

Currently, the NASD rules require disclosure of certain specified conflicts of interest to the extent applicable. These disclosures include situations in which the firm:

- was making a market in the recommended securities, or the underlying security if the recommended security is an option or security future, or that the member or associated person will sell to or buy from customers on a principal basis;
- and/or its officers or partners have a financial interest in the securities of the recommended issuer and the nature of the financial interest, unless the extent of the financial interest is nominal; and
- was manager or co-manager of a public offering of any securities of the issuer whose securities are recommended in the past 12 months.

New FINRA Rule 2210(d)(7)(A) retains the first and third requirements, but modifies the second so that a retail communication that includes a recommendation of securities must disclose, if applicable, that the firm or any associated person directly and materially involved in the preparation of the content has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal.

The Communications Rules also carry forward the current requirement that firms provide, or offer to furnish upon request, available investment information supporting the recommendation and (if the recommendation is for an equity security) to provide the price at the time the recommendation is made.

FINRA Rule 2210(d)(7)(C) amends the current provisions governing communications that include past recommendations to mirror those found in Rule 206(4)-1(a)(2) under the Investment Advisers Act of 1940. FINRA Rule 2210(d)(7)(C), like Rule 206(4)-1(a)(2), generally prohibits retail communications from referring to past specific recommendations of the firm that were or would have been profitable to any person. The rule allows, however, a retail communication or correspondence to set out or offer to furnish a list of all recommendations as to the same type, kind, grade or classification of securities made by the firm within the immediately preceding period of not less than one year. The list must provide certain information regarding each recommended security and include a prescribed cautionary legend warning investors not to assume that future recommendations will be profitable.

FINRA Rule 2210(d)(7)(D) expressly excludes from the above requirements communications that meet the definition of “research report” for purposes of NASD Rule 2711 and that include all of the applicable disclosures required by that rule. FINRA Rule 2210(d)(7)(D) also excludes any communication that recommends only registered investment companies or variable insurance products, provided that such communications must have a reasonable basis for the recommendation.

## Public Appearances

Under the Communications Rules, the term “public appearance” is no longer a separate communication category. Nevertheless, FINRA Rule 2210(f) sets forth many of the same general standards that currently apply to public

appearances. If an associated person recommends a security in a public appearance, the associated person must have a reasonable basis for the recommendation. The associated person also must disclose, as applicable:

- that the associated person has a financial interest in any of the securities of the issuer whose securities are recommended, and the nature of the financial interest, unless the extent of the financial interest is nominal; and
- any other actual, material conflict of interest of the associated person or firm of which the associated person knows or has reason to know at the time of the public appearance.

Rule 2210(f) also requires firms to establish appropriate written policies and procedures to supervise public appearances, and makes clear that scripts, slides, handouts or other written (including electronic) materials used in connection with public appearances are considered communications for purposes of FINRA Rule 2210. These disclosure requirements regarding securities recommendations do not apply to (i) a public appearance by a research analyst for purposes of NASD Rule 2711 that includes all of the applicable disclosures required by that rule or (ii) a recommendation of investment company securities or variable insurance products, provided that the associated person must have a reasonable basis for the recommendation.

## Conclusion

The Communications Rules generally will simplify the compliance task of member firms, by reducing the number of categories of communications and standardizing the pre-approval, filing and content standard applicable to each, while maintaining the core requirements of the prior NASD rules. Member firms should review their compliance policies and procedures to ensure they are in line with the Communications Rules in advance of February 2013.

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