

SEC Approves New FINRA Rules on Communications with the Public

Over the course of the last few years, the Financial Industry Regulatory Authority, Inc. (“FINRA”) has proposed changes to the rules governing broker-dealer communications with the public. After receiving significant comments on earlier proposals, FINRA recently announced that the Securities and Exchange Commission (“SEC”) has now approved the proposed rule change, as modified by Amendments Nos. 1, 2, and 3, and will be effective as of February 4, 2013. The FINRA notice is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p127014.pdf>. An overview of the rule changes is provided below. For further discussion of the prior proposals, please refer to the following Client Alerts:

- Original FINRA Regulatory Notice (09-55) Proposal: <http://www.chapman.com/media/news/media.728.pdf>
- July 2011 FINRA Proposal Filed with the SEC: <http://www.chapman.com/media/news/media.1049.pdf>
- November 2011 Amendment No. 1 to Proposal: <http://www.chapman.com/media/news/media.1098.pdf>
- December 2011 Amendment No. 2 to Proposal: <http://www.chapman.com/media/news/media.1133.pdf>

Overview of the Proposed Rule Changes

Given the extended period of time the proposed rule changes have been under consideration, and in light of the several amendments made thereto, the following sections summarize key provisions from the most recent version.

Background

The new FINRA Rules include:

- FINRA Rule 2210 (Communications with the Public),
- FINRA Rule 2212 (Use of Investment Companies Rankings in Retail Communications),
- FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings),
- FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools),

- FINRA Rule 2215 (Communications with the Public Regarding Security Futures), and
- FINRA Rule 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs)).

These new rules replace current NASD Rules 2210 and 2211, the Interpretive Materials that follow NASD Rule 2210, and portions of Incorporated NYSE Rule 472. The current rules generally govern communications with the public by FINRA member firms and include approval, filing, and content standards. These standards provide a framework for evaluating facts and other information contained in communications that may make such communications misleading as they pertain to a particular security, industry, or service.

New Communication Categories

Although largely based upon current provisions, the changes create new communications categories and require the filing of certain types of communications

currently not required to be filed. NASD Rule 2210 currently defines “communications with the public” to include six separate categories of communications: (i) advertisements; (ii) sales literature; (iii) correspondence; (iv) institutional sales material; (v) public appearances; and (vi) independently prepared reprints. Each category is subject to different approval, filing, and content standards.

The rule change consolidates the six current communication categories listed above to three:

- *Correspondence*: any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period;
- *Retail Communication*: any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period, including any person other than an institutional investor, regardless of whether the person has an account with the member; and
- *Institutional Communication*: any written (including electronic) communication that is distributed or made available only to institutional investors (not including a member’s internal communications).

Communications that currently qualify as “advertisements” and “sales literature” generally fall under the new definition of “retail communication.” Communications that currently qualify as “institutional sales material” generally fall within the new definition of “institutional communication.” Some communications that currently qualify as “correspondence” continue to fall within that definition, though the definition is not limited to form letters, market letters, electronic messages, or instant messages, as it is under the current rules. However, communications sent to more than 25 retail investors within any 30 calendar-day period are considered “retail communications” under the new rule. The terms “public appearance” and “independently prepared reprint” are eliminated under the new rule, though the exceptions from the filing requirements and limited application of the content standards currently applicable to those categories largely continue. Additionally, public appearances that include recommendations of securities will now be subject to new disclosure standards.

New Approval, Review, and Recordkeeping Requirements

FINRA Rule 2210 requires an appropriately qualified registered principal of a firm to approve certain retail communications before the earlier of its use or filing with FINRA. The principal registration required to approve particular communications depends upon the permissible activities for each principal registration category. FINRA may grant an exemption from the principal approval requirements for good cause shown after taking into consideration all relevant factors.

FINRA Rule 2210(b)(4)(A) sets the recordkeeping requirements for retail and institutional communications. The provision incorporates by reference the recordkeeping form and time period requirements of Rule 17a-4 under the Securities Exchange Act of 1934. Such 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 retail communication or an institutional 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 any retail communication for which principal approval is not required, the name of the member that filed the retail communication and a copy of the corresponding review letter.

FINRA Rule 2210(b)(4)(B) cross-references NASD Rules 3010(d)(3) and FINRA Rule 4511 with respect to correspondence record-keeping requirements.

New Filing Requirements and Review Procedures

FINRA Rule 2210(c) requires a new member to file all of its retail communications for a one-year period beginning on the effective date it becomes registered with FINRA. In response to comments, FINRA narrowed the scope to include only retail communications that are published or

used in any electronic or other public media. This narrowing requires new firms to file only retail communications that currently fall within the NASD Rule 2210 definition of “advertisement,” thus not changing the scope as compared to current standards. Retail communications concerning registered investment companies are not subject to the filing requirement covering structured products communications since they are subject to separate requirements in other provisions. Furthermore, the filing requirement only applies to retail communications concerning structured products that are registered under the Securities Act of 1933.

The new rule excludes from the filing requirements previously filed retail communications that are used without material change, including retail communications that are based on templates. NASD Rule 2210 includes the same filing exclusion for previously filed advertisements and sales literature that are used without material change, but does not contain any express filing exclusion for templates.

In response to comments received over the course of the proposal and its several amendments, the new rule excludes several communication types from the filing requirements, including, among others:

- Retail communications that do not make any financial or investment recommendation or otherwise promote a product or service of the member;
- Reprints and excerpts of certain articles and reports produced by independent third parties, including independent research reports on registered investment companies which are excluded from filing under the current rules;
- Retail communications that are posted on an online interactive electronic forum; and
- Press releases issued by closed-end investment companies that are listed on the New York Stock Exchange pursuant to section 202.06 of the NYSE Listed Company Manual.

Content Standards

FINRA Rule 2210(d) reorganizes, but largely incorporates, the current content standards applicable to communications with the public that are found in NASD Rule 2210(d), NASD IM-2210-1, NASD IM-2210-4 and Incorporated NYSE Rules 472(i) and (j), subject to certain changes. Content standards that currently apply to

advertisements and sales literature will generally apply to retail communications. Among other things, the new rule also:

- Expressly prohibits promissory statements or claims;
- Carries forward the current prohibition of performance predictions and projections, as well as the allowance for hypothetical illustrations of mathematical principles, but clarifies that two types of projections of performance in communications with the public are permitted—projections of performance in reports produced by investment analyst tools that meet the requirements of NASD IM-2210-6 and research reports on debt or equity securities to include price targets under certain circumstances;
- Applies the standards concerning disclosure of a firm’s name to correspondence as well as to retail communications;
- Applies standards concerning comparative illustrations of the mathematical principles of tax-deferred versus taxable compounding to any illustration, regardless of whether it appears in a communication promoting variable insurance products or some other communication, including disclosure that ordinary income tax rates will apply to withdrawals from a tax-deferred investment. Illustrations are permitted to reflect an actual state income tax rate if prominently and properly disclosed as applicable only to residents of such state;
- Requires communications with the public (other than institutional sales material and correspondence) that presents the performance of a non-money market mutual fund to disclosure of the maximum sales charge and total operating expense ratio based on the fund’s prospectus or annual report, whichever is more current;
- Requires retail communications that include a recommendation to: (i) have a reasonable basis for the recommendation of securities; (ii) disclose if the member was making a market in the security (or underlying security in the case of an option or future) or that the member or associated persons will sell to or buy from its customers; (iii) disclose if the member or any associated person that is directly and materially involved in the preparation of the content of the communication has a non-nominal financial interest in any of the securities and, if so, the nature of such interest; and (iv) disclose if the member was

manager or co-manager of a public offering of any securities of the issuer whose securities are recommended within the past 12 months;

- Requires a member to offer to furnish upon request available investment information supporting a recommendation;
- Requires a member that recommends a corporate equity security to provide the price at the time the recommendation is made;
- Excludes from the recommendations requirements any communication that meets the definition of “research report” and includes the disclosures required by NASD Rule 2711; and
- Excludes from the proposed content standards prospectuses, preliminary prospectuses, fund profiles, and similar documents that have been filed with the SEC.

FINRA Rule 2210(e) replaces current NASD IM-2210-4, which addresses limitations on firms’ use of FINRA’s name and any other corporate name owned by FINRA. This provision codifies FINRA’s current position that any reference to FINRA staff’s review of a communication be limited to either “Reviewed by FINRA” or “FINRA Reviewed.”

FINRA Rule 2210(f) sets forth that public appearances have to meet the general “fair and balanced” standards and the standards applicable to recommendations discussed above if the public appearance included a recommendation of a security. Such standards, however, now apply only to public appearances by associated persons. An associated person must disclose any applicable financial interest in any securities of the issuer whose securities are recommended and the nature of the financial interest (unless nominal). Any actual, material conflicts of interest of the member or the associated person that the associated person knows of, or has reason to know of, at the time of the public appearance must be disclosed. Any public appearance by a research analyst for purposes of NASD Rule 2711 is not affected by this disclosure requirement. The disclosure requirements also do not apply to a recommendation of investment company securities or variable insurance products if the associated person has a reasonable basis for the recommendation. Firms are required to establish appropriate written policies and procedures to supervise public appearances. Scripts, slides, handouts, or other written and electronic materials

used in connection with public appearances are considered “communications” for purposes of the rule.

Use of Investment Company Rankings in Retail Communications

FINRA Rule 2212 replaces NASD IM-2210-3 with regard to standards applicable to the use of investment company rankings in communications. The existing standards generally remain the same, but apply to retail communications instead of advertisements and sales literature. New paragraph (h) excludes from coverage reprints or excerpts of articles or reports that are excluded from FINRA’s filing requirements pursuant to Rule 2210(c)(7)(I).

Requirements for the Use of Investment Analysis Tools

FINRA Rule 2214 replaces NASD IM- 2210-6 with regard to standards applicable to the use of investment analysis tools with retail customers. The standards largely remain the same, but some language currently contained either in the text or footnotes of IM-2210-6 now become supplementary material.

Communications with the Public Regarding Security Futures

FINRA Rule 2215 replaces NASD IM-2210-7 with regard to standards applicable to communications concerning security futures and revises the current standards to conform to NASD Rule 2220 in several respects. First, the new rule applies to all retail communications rather than just to advertisements. Second, a communication concerning security futures must be accompanied or preceded by the risk disclosure document if it contains the names of specific securities. Third, the new rule prohibits security future communications that contain any statement suggesting the certain availability of a secondary market for security futures. Fourth, the new rule also requires any statement referring to the potential opportunities or advantages presented by security futures to be accompanied by a statement of the corresponding risks, and requires the same degree of specificity. Finally, the new rule clarifies that communications that contain the historical performance of security futures must disclose all relevant costs, which must be reflected in the performance.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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