

FINRA Proposal to Allow Broker-Dealers to Distribute Predictive Illustrations

Amendment to FINRA Communications Rule would put member firms on a more equal footing with investment advisers.

In February 2017, the Financial Industry Regulatory Authority, Inc. (FINRA) announced a proposed amendment (Proposed Amendment) to FINRA Rule 2210 (Communications with the Public),¹ which would allow member firms to provide customized predictive performance illustrations to current and prospective customers under limited circumstances.

Currently, FINRA Rule 2210(d)(1)(F) prohibits member firms from providing customers with materials that “predict or project performance” of securities.² Both the securities industry and its customers have long chafed against this rule, as customers have sought issuer projections and predictive portfolio modelling. With the Proposed Amendment, FINRA has carved out a narrow exemption from the prohibition on performance projections for “customized hypothetical investment planning illustrations”³ regarding investment strategies or multiple assets when certain criteria have been met. Specifically, the member firm must have a “reasonable basis” for any assumptions and conclusions in the projection, the projection must be prominently marked as hypothetical and any material assumptions must be clearly disclosed. While the Proposed Amendment is somewhat narrow (it does not apply to projections on single securities), it continues an evolving trend in this area. The Proposed Amendment follows FINRA’s approval in August 2016 of the Capital Acquisition Broker rules (the CAB Rules), which do not include the general prohibition against projections.⁴ Of course, the CAB Rules apply only to Capital Acquisition Brokers marketing to institutional investors, while the Proposed Amendment would apply to all broker-dealers and investors.

The current rule carves out only the extremely narrow “hypothetical illustrations of mathematical principles” and “investment analysis tools compliant with FINRA Rule 2214” from the prohibition on projections. The Proposed Amendment expands on these exceptions substantially and would permit broker-dealer representatives to present projections for model portfolios to customers, such as asset allocation models and others. Of course, as stated above, the primary compliance condition in the Proposed Amendment is that the projections have a reasonable basis for the underlying assumptions. FINRA provided examples of what should be considered in this regard, including “the historical performance and performance volatility of asset classes, the duration of fixed income investments, the effects of macroeconomic factors such as inflation and changes in currency valuation, the impact of fees, costs and taxes, and expected contribution and withdrawal rates by the customer.”⁵ FINRA noted that a projection that relies too heavily on any one of these factors could be unreasonable.

Supervision continues to be a key element of compliance with FINRA’s customer communications rule. The Proposed Amendment would require member firms to have a registered principal review any

hypothetical illustration for compliance prior to delivery to the customer. The Proposed Amendment would also permit the use of templates that have been reviewed by a registered principal.⁶

For member firms, the change better aligns FINRA's requirements for customer communications with those of the Securities and Exchange Commission governing registered investment advisers. The Proposed Amendment would allow member firms to provide the same types of customized predictive modeling that investment advisors provide to their clients, removing an impediment to competition with investment advisers, while also simplifying compliance for dually registered member firms. In addition, as member firms increasingly turn to algorithms for analysis,⁷ the Proposed Amendment would allow member firms to share these analyses with their customers. The Proposed Amendment would also simplify the compliance concerns around algorithmic modeling tools used by financial advisers and their clients.

To date, FINRA has published two responses to its request for comments.⁸ In each case, the responses are supportive of the proposed amendment. The comment period closed March 27, 2017.

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Endnotes

- ¹ Regulatory Notice 17-06 "Communications with the Public" available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-06.pdf
- ² FINRA Rule 2210(d)(1)(F) provides limited exceptions from this prohibition for (i) hypothetical illustrations of mathematical principles; (ii) investment analysis tools compliant with FINRA Rule 2214; and (iii) price targets in debt or equity research reports with a reasonable basis and disclosure; and FINRA Rule 2220(d)(3) allows for certain projections relating to futures and options. The proposed exemption for customized hypothetical investment illustrations will be in addition to those listed above.
- ³ Proposed Rule 2210(b)(4) and (d)(1)(F)(iv), *id.* at p. 8-10.
- ⁴ For additional information on the CAB Rules, see [LW Client Alert No. 2001, "SEC Approves FINRA's Capital Acquisition Broker Rules," August 29, 2016.](#)
- ⁵ Regulatory Notice 17-06 at p. 3
- ⁶ The supervisory review and approval process would be required to comply with FINRA Rule 3110. FINRA acknowledges that additional supervisory requirements with respect to the creation of templates or the approval of individual hypothetical illustrations as well as any required updates to a member firm's policies and procedures could generate costs for member firms, however, member firms are not required to provide their customers with these types of projections simply because an exemption is available to them.
- ⁷ See Barrons, "Merrill Plugs in its Robo-Advisor," February 8, 2017, available at <http://www.barrons.com/articles/merrill-plugs-in-its-robo-advisor-1486591094>, and "Goldman Sachs Eyeing a Robo-Advisor," March 21, 2017, available at <http://www.barrons.com/articles/goldman-sachs-eyeing-a-robo-advisor-1490120240>
- ⁸ Equity Dealers of America, March 7, 2017, and NPB Financial Group LLC, March 9, 2017.