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December 15, 2023

VIA ELECTRONIC SUBMISSION

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: ***Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 2210 (Communications with the Public) to Permit Projections of Performance of Investment Strategies or Single Securities in Institutional Communications*** **(Release No. 34-98977; File No. SR-FINRA-2023-016)**

Dear Ms. Countryman:

Dechert LLP appreciates the opportunity to provide comments on the above referenced proposal by the Financial Industry Regulatory Authority, Inc. ("**FINRA**") to amend FINRA Rule 2210 (the "**Proposed Amendments**").[1] The Proposed Amendments would permit the use of targeted returns and projected performance in certain limited circumstances and subject to certain specified conditions.

We applaud FINRA's efforts to conform Rule 2210 with the standards for presentation of hypothetical performance adopted by the Securities and Exchange Commission ("**Commission**") in amended Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the "**Marketing Rule**").[2] The alignment of regulatory standards would be a welcome change for investors, private fund managers and placement agents, as FINRA's current rule requires FINRA members to withhold certain information from sophisticated investors, although the same information may be provided by private fund managers directly. However, the Proposed

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Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Our clients include, among others, a wide variety of private funds and private fund sponsors, investment advisers, broker-dealers and institutional investors. An extensive part of our services for these clients involves assistance with the federal securities laws in the organization, distribution and marketing of investment funds. In developing these comments, we have drawn on our extensive experience in the financial services industry generally. The comments herein reflect our own views and not necessarily the views of our clients.

[1] Communications with the Public, Exchange Act Release No. 98977, 88 Fed. Reg. 82482 (Nov. 24, 2023) ("**Proposing Release**").

[2] 17 CFR §275.206(4)-1.

Amendments remain inconsistent with the Marketing Rule in many respects, and their application would be ambiguous in others.

As discussed in greater detail herein, we recommend the following changes to address certain unanswered questions and interpretive issues in the Proposed Amendments, and to better align the Proposed Amendments with the Marketing Rule:

- Remove the prohibition on targeted returns and projected performance calculated based on hypothetical, backtested performance or the prior performance of a portfolio or model created solely for the purpose of establishing a track record.
- Remove the requirement to adopt policies reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor.
- Clarify that the internal rate of return ("**IRR**") of an actual investment program, even if based in whole or in part on the performance of unrealized investments, is not a targeted return or projected performance for purposes of the application of Rule 2210.
- Align the treatment of extracted performance under Rule 2210 with the Marketing Rule and the Private Fund Adviser Rules.
- Adjust the recordkeeping obligations associated with the "reasonable basis" requirement to avoid unnecessary and onerous obligations for third-party distributors and placement agents.
- Expand the universe of permitted recipients of targeted returns and projected performance in the Proposed Amendments to include Knowledgeable Employees.

A. Remove the Supplementary Material Prohibition on Certain Targeted Returns and Projected Performance

We strongly support the stated purpose of the Proposed Amendments—to permit the use of targeted returns and projected performance in material shared with sophisticated investors, consistent with the Marketing Rule standards for hypothetical performance. However, the utility of the Proposed Amendments is limited by the inclusion of Supplementary Material .01(b) to Rule 2210, which *prohibits* the calculation of targets and projections based on the use of hypothetical, backtested performance or the prior performance of a portfolio or model created solely for the purpose of establishing a track record. These prohibitions diverge from the treatment of hypothetical performance in the Marketing Rule and would limit the practical application of the Proposed Amendments. Private fund managers often establish model portfolios and seed accounts in advance of launching a new product and rely on backtests to assess how investment strategies would have performed in different market environments. Sophisticated investors routinely request this information to inform diligence efforts, the importance of which has recently been

acknowledged by the Commission.[3] Under the Marketing Rule, backtests, models and seed accounts used only to establish performance records are treated as hypothetical performance that may *only* be shared with sophisticated investors subject to conditions substantially similar to those in the Proposed Amendments. Rather than aligning the treatment of these forms of performance to the Marketing Rule, the Supplementary Material prohibits them entirely. This incongruity would result in inconsistent market practices, unnecessary hurdles to investor due diligence, and greater potential for investor confusion. We respectfully recommend that FINRA reconsider this approach and fully align this aspect of the Proposed Amendments with the Marketing Rule.

The release accompanying the Proposed Amendments (the "**Proposing Release**") does not substantively address these inconsistencies between the Proposed Amendments and the Marketing Rule. The Proposing Release's citation to an SEC staff no-action letter that was issued in a different context and before the Marketing Rule should not be given more weight than the Commission's more recent and more relevant discussion of the same issue in the Marketing Rule adopting release.[4] After initially proposing to treat all non-client accounts as hypothetical performance, the Commission elected instead to treat certain seed accounts as actual performance and other seed accounts with characteristics similar to those cited in the Proposed Amendments as hypothetical performance rather than actual performance. We encourage FINRA to adopt the same approach in Rule 2210.

With respect to backtesting, we agree with the position stated by NASAA in 2017 that "a certain degree of backtesting would appear virtually inevitable in the creation of any hypothetical portfolio."[5] Stated differently, it is unclear what policy objective could be served by *prohibiting* FINRA members from using rigorous backtests to assess whether targets and projections are reasonable. Rather than addressing this point, FINRA stated its belief that industry comments regarding backtested performance "extend beyond the scope of the proposal's intent, and thus are not germane to this proposed rule filing."[6] We believe the treatment of backtests is not only

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[3] *See* Investment Adviser Advertisements; Compensation for Solicitations, Advisers Act Release No. 5407, 84 Fed. Reg. 67518, 67560 (Dec. 10, 2019) ("An investor conducting diligence on a newly launched quantitative investment strategy, for instance, may request backtested performance to further analyze the adviser's quantitative model as well as the assumptions, inputs, and quantitative parameters used by the adviser. The investor may request backtested performance to determine how the adviser adjusted its model to reflect new or changed data sources. An investor with the resources to assess the backtested performance may also gain an understanding of other aspects of the investment strategy, including exposures and risk tolerances in certain market conditions, and develop reasonable expectations of how the strategy might perform in the future under different market conditions.").

[4] *See* MassMutual Institutional Funds, SEC Staff No Action Letter (Sept. 28, 1995); Investment Adviser Marketing, Advisers Act Release No. 5653, 86 Fed. Reg. 13024, 13079 (Mar. 5, 2021) ("**Marketing Rule Release**") ("…advisers should not invest a nominal amount of assets in a portfolio in an effort to ***avoid*** the "hypothetical performance" designation.") (emphasis added).

[5] NASAA, Comment to Regulatory Notice 17-06 (Mar. 24, 2017).

[6] Proposing Release at 58.

germane, but essential to the Proposed Rules, as (i) the stated purpose of the Proposed Amendments is to align Rule 2210 with the Marketing Rule, and excluding backtests would confound this goal; (ii) NASAA's comment above clearly demonstrates how backtesting is relevant to other elements of the Proposed Amendments; and (iii) the Proposed Amendments address the treatment of backtesting directly. If FINRA is concerned that permitting the use of backtesting to form a reasonable basis for a target or projection would result in member firms misrepresenting hypothetical, backtested performance as actual performance, we recommend instead that FINRA address this concern by requiring prominent identification of targets and projections based on backtests and disclosures regarding the reliability of such information. We believe that these or similar measures are already common practice under a "fair and balanced" standard. But this approach, at least, would mitigate the risk introduced by the current proposal that members will withhold relevant information from investors or forego beneficial testing of the criteria and assumptions underpinning targets and projections for fear that the testing would be considered a backtest.

For the reasons discussed above, FINRA should remove Supplementary Material .01(b) and clarify that targets and projections may be based on hypothetical, backtested performance. In addition, to address any concerns that performance of seed accounts formed for the purpose of establishing a track record may be misleading, FINRA should (consistent with Commission guidance) clarify that targets and projections based on such accounts are permitted under, but subject to, the Proposed Amendments.

B. Remove Redundant Sophistication Requirements

The Proposed Amendments impose two distinct limitations on the types of investors that may receive targeted returns and projected performance: one limitation that is similar to the requirements of the Marketing Rule, and one that imposes new, additional requirements. First, members would need to adopt policies and procedures reasonably designed to ensure that communications with targets and projections are relevant to the likely financial situation and investment objectives of the recipient. This standard mirrors the Marketing Rule standard, which was adopted by the SEC *rather than* prescribing a particular class or classes of investors for which hypothetical performance would be appropriate.[7]

In addition, the Proposed Amendments would limit the use of targeted returns and projected performance only to two sophisticated classes of investors: institutional investors and qualified purchasers (in offerings limited to qualified purchasers). Given that express limitation, the requirement that members separately determine that the performance is relevant to the intended audience appears unnecessary and redundant. Members may reasonably question whether the Proposed Amendments impose some additional obligation to narrow the target audience beyond institutional investors and qualified purchasers. This is not a feature of most fund managers'

[7] Marketing Rule Release at n. 671 and accompanying text.

existing policies designed to comply with the Marketing Rule and would further limit the utility of the Proposed Amendments.

Accordingly, although the requirement in the Proposed Amendments that FINRA members develop policies and procedures that are reasonably designed to ensure compliance with Rule 2210 (including procedures to ensure targets and projections are disseminated only to institutional investors and qualified purchasers) is reasonable, we recommend that FINRA omit the redundant requirement to develop policies designed to ensure the intended audience is sufficiently sophisticated.

C. Address Uncertainties Regarding Treatment of IRRs

In 2020, FINRA issued guidance to members regarding certain marketing practices in connection with private offerings, including the treatment of internal rates of return ("**IRRs**").[8] In this guidance, FINRA explicitly stated that IRRs of investment programs that have no operations or that operate as a blind pool would be inconsistent with the prohibition on projections in Rule 2210. The guidance also provided that the IRRs of investment programs with a combination of realized and unrealized holdings would comply with Rule 2210 if calculated in a manner consistent with the Global Investment Performance Standards ("**GIPS®**"), implicitly suggesting that other representations of the performance of investment programs with a combination of realized and unrealized holdings do not comply with Rule 2210. Subsequent FINRA "FAQs" (discussed in the following section) also refer to unrealized positions as projections with no "actual" performance. The Marketing Rule imposes no similar conditions on the calculation or presentation of IRR, and generally treats IRR as actual performance even when unrealized positions are included in the calculation.

The treatment of FINRA's prior guidance on the calculation and presentation of IRR is unclear under the Proposed Amendments. The Proposing Release only discusses IRR in the context of communications that are assumed to be performance projections, noting that the need for cautionary disclosures "is particularly true when a projection is expressed as an internal rate of return" because "forward-looking IRR" is "calculated on the basis of future cash flows to and from investors." It is unclear from this limited discussion whether IRR calculated in accordance with GIPS would continue to be treated as actual performance and therefore outside the scope of the Proposed Amendments, and if IRR or other measures of performance that ascribe values to unrealized positions but that are not calculated in accordance with GIPS would be treated as projections.

FINRA should address these interpretive questions in the final rule or accompanying guidance. To the extent that FINRA is seeking to align its performance standards with the Marketing Rule, GIPS, and general industry standards, any such guidance should provide that the

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[8] FINRA Regulatory Notice 20-21 (July 2020), https://www.finra.org/rules-guidance/notices/20-21.

IRR for actual investments or investment programs, even when based in whole or in part on IRRs of unrealized positions, is not a projection of performance. We submit that this is the better approach, and FINRA should not treat the valuation of an actual asset as a "projection." The performance of assets that have been purchased and can be valued is actual performance; this is as true for private assets with fair values as it is for liquid assets with market values.

D. Address Treatment of Extracted Performance

The Proposed Amendments and the Proposing Release also do not address FINRA's position with respect to extracted performance. FAQs D.6.2 and D.6.3 currently 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).[9] These FAQs are not, by their terms, limited to retail communications, and if they are not withdrawn or otherwise addressed in the Proposed Amendments, they will continue to require inconsistent treatment of extracted performance under the Marketing Rule and Rule 2210.

In January 2023, the SEC staff published guidance that the performance of individual holdings (realized or unrealized) would be treated as "extracted performance" under the Marketing Rule.[10] By contrast, FAQ D.6.2 states that the performance of an unrealized holding would represent a prohibited projection under Rule 2210. Consequently, this performance information may be distributed to the general public under the Marketing Rule, subject to certain conditions, but could only be shared with a limited audience under the Proposed Amendments. Similarly, the performance of a subset of holdings of a private fund representing only the fund's realized holdings is treated as "extracted performance" under the Marketing Rule, but is prohibited by FAQ D.6.3.

FINRA's positions in these FAQs are also inconsistent with the Private Fund Adviser Rules, which expressly require that quarterly statements include the gross IRR and gross multiple on invested capital ("**MOIC**") for the realized and unrealized portions of an illiquid fund's portfolio.[11] In the adopting release for the Private Fund Adviser Rules, the Commission stated that "disclosure of realized and unrealized performance will provide investors with important context for analyzing the adviser's valuations and for weighing their impact on the fund's overall performance." The Commission also stated that the presentation of the aggregate realized

[9] FINRA Frequently Asked Questions About Advertising Regulation, D.6.2 and D.6.3 (Sept. 30, 2021), https://www.finra.org/rules-guidance/guidance/faqs/advertising-regulation#d6.

[10] Marketing Compliance Frequently Asked Questions (Jan. 11, 2023), https://www.sec.gov/investment/marketing-faq.

[11] 17 CFR §275.206(4)-1(d)(5); 17 CFR §275.211(h)(1)-2(e)(2)(ii)(A).

performance of a portfolio would prevent investors from being misled to the extent that valuations of unrealized positions inflate fund-level returns.[12]

We urge FINRA to consider the Commission's positions on individual unrealized and aggregate realized returns. Specifically, FINRA should withdraw FAQs D.6.2 and D.6.3, and clarify in connection with any final rule that (i) the performance of unrealized individual holdings is permissible actual performance; and (ii) aggregate realized performance of an investment program that also has unrealized holdings is permissible as actual performance and is not *per se* misleading. To the extent FINRA believes that these performance metrics merit additional safeguards, we recommend that FINRA align its approach with the Commission's treatment of extracted performance under the Marketing Rule.

E. Clarify the Requirement to Retain Written Records of a Member's Reasonable Basis

If adopted as proposed, the "reasonable basis" standard—which is not an element of the Marketing Rule's hypothetical performance requirements but is reflected in the Marketing Rule's general prohibitions—will create new, onerous obligations for many distributors and placement agents of private funds. This is particularly true where a placement agent is not in a control relationship with the fund manager. Pursuant to the Proposed Amendments, a third-party placement agent would need to perform sufficient diligence on the criteria used and assumptions established by the fund manager to support the calculation of targets or projections ultimately contained in member communications and retain written records supporting the basis for such criteria and assumptions. The Proposing Release suggests that such diligence may include inquiries into the source and accuracy of the data used, the rigor of the analysis, and the date and timeliness of any research used, among other things.

FINRA members should have a reasonable basis to believe that the criteria used and assumptions made in calculating targeted returns or projected performance are appropriate and not misleading, regardless of the party responsible for the calculations. However, the obligation to retain written records "supporting the basis for criteria and assumptions" could be interpreted to mean that the FINRA member *itself* must retain all backup data, calculations, and assumptions used by a fund manager in the computation of targets and projections. This obligation—which is distinct from the diligence requirement—appears to require access to and retention by the broker of materials that fund managers rightly consider trade secrets. Even if access and retention of this data by the FINRA member is feasible, it is not clear that a separate obligation to retain written records supporting the basis of criteria and assumptions originally used by a third-party fund manager advances the interest of investor protection.

We suggest instead that the FINRA member's obligation should be to (i) establish a reasonable basis to believe that the criteria used and assumptions made in calculating the targeted

[12] Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 6383, 88 Fed. Reg. 63206, 63244 (Sept. 14, 2023).

return or projected performance are appropriate and not misleading, and (ii) retain written records supporting such reasonable basis. Where the FINRA member itself is responsible for the computation of targets and projections, this will be achieved through retention of the basis for the criteria and assumptions. Where the FINRA member is only testing the integrity of targets and projections prepared by a fund manager (as will often be the case), requiring records that demonstrate this testing process will better focus the member on the importance of its role as a gatekeeper.

F. Clarify Application to Knowledgeable Employees

The Proposed Amendments would allow a member to distribute projected performance or targeted returns in an institutional communication or a communication distributed solely to qualified purchasers (as defined in the Investment Company Act) that promotes or recommends specified private offerings. However, Rule 3c-5 under the Investment Company Act also permits the sale of interests in private funds relying on Section 3(c)(7) of the Investment Company Act to "Knowledgeable Employees" of the private fund or its manager, even if the Knowledgeable Employees are not qualified purchasers. This exception to the general requirement that a fund relying on Section 3(c)(7) be owned exclusively by qualified purchasers was established by the Commission to reduce unnecessary burdens for certain executive officers and investment professionals of private funds relying on Section 3(c)(7) and their managers, without jeopardizing investor protection.[13]

We respectfully recommend that FINRA expand the universe of permitted recipients of targeted returns and projected performance in the Proposed Amendments to include Knowledgeable Employees. We do not believe that executive officers and investment professionals with intimate knowledge of the operations of private funds marketed in member communications to the public are the intended beneficiaries of the protective limitations imposed by the Proposed Amendments, and this change would more closely align the Proposed Amendments with the Commission's treatment of Section 3(c)(7) of the Investment Company Act.

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[13] Privately Offered Investment Companies, Investment Company Act Release No. 22597, 62 Fed. Reg. 17512, 17525 (Apr. 9, 1997) ("[T]he rules would clarify the statutory requirements for privately offered funds in order to reduce any unnecessary burdens without jeopardizing investor protection.").

We appreciate FINRA's consideration of our comments on the Proposed Amendments and would be happy to provide any additional information that may be helpful. Please contact Michael McGrath (michael.mcgrath@dechert.com or +1 617 728 7178) or Lindsay Grossman (lindsay.grossman@dechert.com or +1 617 728 7183) if we can be of further assistance.

Sincerely,

/s/ Dechert LLP

Dechert LLP