Meredith Cordisco
Associate General Counsel
Office of General Counsel

Direct: (202) 728-8018
Fax: (202) 728-8264

February 22, 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 would amend FINRA Rule 2210 (Communications with the Public) to allow a member to project the performance or provide a targeted return with respect to a security or asset allocation or other investment strategy in an institutional communication or a communication distributed solely to qualified purchasers as defined in the Investment Company Act of 1940 ("Investment Company Act" or "ICA") that promotes or recommends specified non-public offerings, subject to stringent conditions to ensure these projections are carefully derived from a sound basis.

The Commission published the proposed rule change for public comment in the Federal Register on November 24, 2023.[1] On January 5, 2024, FINRA consented to an extension of the time period for SEC action on the proposed rule change to February 22, 2024. The Commission received ten comment letters on the proposed rule change.[2]

In light of the comments received, FINRA proposes to amend the proposed rule change, as set forth in Partial Amendment No. 1, to marginally expand the proposed

---

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).

2 See Attachment A: Alphabetical List of Commenters to File No. SR-FINRA-2023-016.

allowance for the use of projections of performance and targeted returns, when the conditions are met, to include a communication that is distributed or made available only to persons meeting the definition of either "qualified purchaser" under the Investment Company Act or "knowledgeable employee" under ICA Rule 3c-5, and that promotes or recommends specified non-public offerings. As discussed in more detail below, FINRA believes that it is appropriate for knowledgeable employees, like qualified purchasers, to be eligible to receive projections of performance and targeted returns in communications that promote or recommend specified non-public offerings, provided that other conditions are met.

The following discusses the Partial Amendment No. 1, as well as FINRA's responses, by topic, to the material points raised in the comments.

I. General Support for Proposal

In general, most commenters supported the overall intent of the proposed rule change.[3] These commenters stated that allowing performance projections will help investors and their agents better assess both the possible returns associated with an investment as well as potential risks, thereby contributing to transparency while enhancing the quality and quantity of information made available to potential investors.[4] They also discussed the benefit of projections in, for example, highlighting important investment concepts such as variability of investment returns, differences in rates of return among asset classes, ways in which asset classes with different performance correlations might be combined to reduce overall portfolio volatility, and the benefit of compound returns over long time horizons.[5]

Several commenters expressed appreciation for closer regulatory harmonization between the relevant standards for broker-dealers and investment advisers.[6] However, some commenters suggested that the proposed rule change fails to mitigate competitive disadvantages facing some broker-dealers[7] and should more freely allow the use of projections of performance.[8] Some commenters requested clarity on aspects of the proposal or advocated for further alignment with the SEC's recently adopted Rule 206(4)-1

---

3 See ABA, ADISA, Dechert, Diggins, ICI, IPA, Nelson Kuiper, SIFMA.

4 See, e.g., ADISA.

5 See ICI.

6 See, e.g., Dechert, IPA, Nelson Kuiper, SIFMA.

7 See Monument Group.

8 See ABA, ADISA, Dechert, ICI, IPA, SIFMA.

("IA Marketing Rule") under the Investment Advisers Act of 1940 ("Advisers Act"), including regarding the scope of the proposal and its conditions, as discussed more thoroughly below. [9]

In its letter, PIABA suggested that FINRA be mindful of the challenges accompanying this proposal and devote adequate resources to ensure investor protection. FINRA appreciates this comment and intends to examine for, and enforce compliance with, the proposed rule change, as it does with its other rules.

II. Scope of Proposal

Rule 2210 currently prohibits member communications from predicting or projecting performance, subject to specified exceptions.[10] The proposed rule change would allow a member to project the performance or provide a targeted return, provided that specified conditions are met, and in communications distributed or made available only to two categories of persons: (1) institutional investors;[11] and (2) qualified purchasers ("QPs")

---

9 See ABA, Dechert, ICI, Monument Group, SIFMA.

10 See Rule 2210(d)(1)(F).

11 Rule 2210(a)(4) provides that "institutional investor" means any:

(A) person described in Rule 4512(c), regardless of whether the person has an account with a member;

(B) governmental entity or subdivision thereof;

(C) employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meet the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and in the aggregate have at least 100 participants, but does not include any participant of such plans;

(D) qualified plan, as defined in Section 3(a)(12)(C) of the Exchange Act, or multiple qualified plans offered to employees of the same employer, that in the aggregate have at least 100 participants, but does not include any participant of such plans;

(E) member or registered person of such a member; and

(F) person acting solely on behalf of any such institutional investor.

Rule 4512(c) defines "institutional account" to mean the account of: (1) a bank, savings and loan association, insurance company or registered investment company;

as defined in the Investment Company Act[12] when the communication promotes or recommends specified non-public offerings.[13]

Several commenters suggested that FINRA expand the scope of the proposed rule change to more broadly allow for the use of projections, both in terms of the potential investors who may receive the information and, with respect to QPs, without regard to any product-specific limitations.[14] Two commenters suggested that the proposal be broadened to include communications to all retail investors.[15] SIFMA stated that retail investors may already receive this information from registered investment advisers, and expanding the rule to retail investors would "provide investors with access to more tools to further FINRA's goals of contributing to investor protection and encouraging the use of registered broker-dealers by issuers over using unregistered firms or marketing securities directly."

SIFMA further noted that the IA Marketing Rule, which permits investment advisers to present hypothetical performance, including "targeted or projected performance returns with respect to any portfolio or to the investment advisory services with regard to

---

(2) an investment adviser registered either with the SEC under Section 203 of the Advisers Act or with a state securities commission; or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

12 See 15 U.S.C. 80a-2(a)(51)(A) (defining "qualified purchaser").

13 The proposed rule change would create a new exception from the prohibition on performance projections for communications that are distributed or made available only to QPs and that promote or recommend either a Member Private Offering that is exempt from the requirements of FINRA Rule 5122 (Private Placements of Securities Issued by Members) pursuant to Rule 5122(c)(1)(B), or a private placement exempt from the requirements of FINRA Rule 5123 (Private Placements of Securities) pursuant to Rule 5123(b)(1)(B). Both Rule 5122(c)(1)(B) and Rule 5123(b)(1)(B) exempt from those rules' requirements private offerings sold solely to QPs, as defined in Section 2(a)(51)(A) of the Investment Company Act.

14 See ABA, ICI, IPA, SIFMA.

15 See ICI, SIFMA. As noted in the rule filing, in most cases, an individual investor who has $5 million or more in investments, but who does not have at least $50 million in assets, will be both a QP under the Investment Company Act and a retail investor for purposes of Rule 2210. Accordingly, some QP private placement communications will be either correspondence or retail communications under the rule.

the securities offered" in an advertisement if the investment adviser meets specified conditions, does not place any express limits on the categories of investors that may receive advertisements containing such performance information.[16] IPA stated that recent regulatory and market developments – including the adoption of SEC's Regulation Best Interest, FINRA's extensive guidance concerning the distribution of private placements,[17] FINRA's filing program under Rules 5122 and 5123, as well as general shifts in the wealth management business – justify the reconsideration of the prohibition on performance projections under FINRA's rule. ICI stated that the limited manner in which projections would be allowed under the proposed rule change is unduly restrictive and prevents FINRA members from communicating in ways that help investors better understand the risk and return characteristics of investments and portfolios.

Some commenters suggested that if the rule proposal is not expanded to allow projections and targeted returns in communications to all retail investors, then it should be amended to permit projections and targeted returns in communications distributed or made available to certain additional investors, such as accredited investors,[18] as defined in Regulation D under the Securities Act of 1933,[19] and "knowledgeable employees," as defined in ICA Rule 3c-5.[20]

While FINRA appreciates commenters' requests to allow members to distribute projections of performance and targeted returns to a wider audience, FINRA continues to believe that it is appropriate at this time to limit the range of potential investors who are eligible to receive communications with projections of performance or targeted returns. The general prohibition against performance projections is intended to protect investors who may lack the capacity to understand the risks and limitations of using projected performance in making investment decisions.

As discussed in the rule filing, FINRA believes that specified, well-established categories of persons that have been previously determined to be financially sophisticated or able to engage expertise for purposes of the securities laws are most capable to understand the risks and limitations of using projected performance, in conjunction with the other safeguards provided in the proposed rule change. To this end, FINRA has proposed to allow members to include projections of performance or targeted returns only

---

16 See Advisers Act Rule 206(4)-1(e)(8)(i)(C).

17 See IPA (citing Regulatory Notices 23-08 (May 2023) and 20-21 (July 2020)).

18 See IPA, SIFMA.

19 See 17 CFR 230.501(a) (defining "accredited investor").

20 See Dechert, SIFMA.

in institutional communications or in communications promoting private placements that are sold only to QPs. In general, private placements sold only to QPs are private funds that are exempt from the Investment Company Act pursuant to ICA section 3(c)(7) ("3(c)(7) funds").[21] Commenters have pointed out, however, that a 3(c)(7) fund may exclude securities beneficially owned by persons meeting the definition of "knowledgeable employee" under ICA Rule 3c-5 from the determination of whether the fund's shares are owned exclusively by QPs.

Accordingly, FINRA believes that it is appropriate to amend the proposed rule change to include – along with QPs – knowledgeable employees in connection with specified non-public offerings as among the categories of investors who may receive communications that include projections or targeted returns, when the proposed rule change's other conditions are met.[22] Knowledgeable employees, as defined in ICA Rule 3c-5, generally include executive officers, directors, trustees, general partners, advisory board members, or persons serving in similar capacities of the fund or certain of its affiliates, and other employees who participate in the investment activities of the fund or certain of the fund's affiliates.[23] Thus, the inclusion of Rule 3c-5 knowledgeable employees would align the scope of persons who may receive communications with projections or targeted returns with the scope of investors permitted to invest in 3(c)(7) funds under the ICA. FINRA believes that these knowledgeable employees typically have intimate knowledge of the operations of private funds, and thus are less likely not to understand the risks and limitations of projections or targeted returns associated with such funds.[24]

FINRA does not agree, however, that members should be allowed to include projections of performance or targeted returns in communications distributed to natural

---

21 ICA section 3(c)(7) provides that a private fund whose securities are owned exclusively by QPs and which is not making a public offering of its securities is not an investment company for purposes of the ICA.

22 As amended, in addition to institutional communications, the proposed rule would permit members to include projections of performance and targeted returns in communications that are distributed or made available only to QPs or knowledgeable employees and that promote or recommend either a Member Private Offering that is exempt from Rule 5122's requirements pursuant to Rule 5122(c)(1)(B), or a private placement that is exempt from Rule 5123's requirements pursuant to Rule 5123(b)(1)(B) or (H).

23 See 17 CFR 270.3c-5(a)(4).

24 See Dechert.

person accredited investors at this time.[25] In adopting Rule 5123, FINRA chose to exempt from the rule's requirements many categories of private placements, including private offerings sold exclusively to QPs and knowledgeable employees.[26] At that time, FINRA purposely chose not to exclude private placements sold to natural person accredited investors, however, despite comments requesting such an exclusion. FINRA stated that it believed that the criteria used to measure whether a person meets the accredited investor standard do not necessarily reflect a sufficiently high level of sophistication to justify an exemption from the proposed rule.[27]

FINRA is making a similar distinction with this proposed rule change. While FINRA is willing to permit members to include projections of performance or targeted returns in communications distributed to either institutional investors, or QPs and knowledgeable employees in connection with a 3(c)(7) fund private offering, at this time, FINRA does not believe that it is appropriate to extend the use of projections of performance and targeted returns to natural person accredited investors, who, as a class, may not possess the same level of financial expertise to evaluate investments and to understand the assumptions and limitations associated with such projections and targeted returns (or have resources that provide them with access to financial professionals who possess this expertise) as the other investors discussed in the proposed rule change (*i.e.*, institutional investors, QPs and knowledgeable employees).[28] Accordingly, FINRA declines to alter the proposed rule change in this manner.

---

25 Under Regulation D, the term "accredited investor" includes, among other persons, any natural person whose income exceeds $200,000 per year, or whose joint marital income exceeds $300,000 per year, or whose net worth or joint net worth (exclusive of the person's primary residence) exceeds $1,000,000. See 17 CFR 230.501(a).

26 See FINRA Rule 5123(b)(1)(B) and (H).

27 See Securities Exchange Act Release No. 67157 (June 7, 2012), 77 FR 35457, 35459-60 (June 13, 2012) (Order Approving File No. SR-FINRA-2011-057).

28 FINRA also notes that the number of households meeting the definition of accredited investor has grown exponentially since the definition was adopted in 1983. In its recent review of the "accredited investor" definition under the Dodd-Frank Act, the SEC staff estimated that in 1983 1.51 million households, or 1.8% of total U.S. households, qualified for this definition. In contrast, in 2022 that number had grown to 24.3 million households, or 18.5% of all U.S. households. See U.S. Securities and Exchange Commission, Review of the "Accredited Investor" Definition under the Dodd-Frank Act (December 14, 2023), page 23, https://www.sec.gov/files/review-definition-accredited-investor-2023.pdf.

Finally, as noted above, three commenters suggested that, with respect to QPs, the proposal be "product agnostic" and not limited to communications that promote or recommend specified non-public offerings.[29] In response, FINRA notes 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 Act.[30] FINRA declines to extend these categories, for purposes of the proposed rule change, beyond that context. As discussed above, FINRA purposely has chosen to tie the exception for communications containing projections and targeted returns to specified private placement exemptions contained in Rules 5122 and 5123. FINRA previously determined that these exemptions appropriately excluded these private offerings from additional review under those rules. FINRA does not believe that, at this time, it can make the same determination concerning communications that contain projections or targeted returns about other types of offerings without further analysis and review.

If adopted, FINRA anticipates monitoring how projections of performance and targeted returns are used for the limited categories of investors, as well as the SEC's experience with hypothetical performance in its recently adopted IA Marketing Rule, in considering whether to further expand the use of projections and targeted returns in the future.

III. Reasonable Basis Requirement

In order for a member to use projections of performance or targeted returns in communications under the proposed rule change, the member must, among other conditions, have a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return, and retain written records supporting the basis for these criteria and assumptions. Proposed Supplementary Material to Rule 2210 includes a non-exhaustive list of factors that members should consider in developing a reasonable basis.

PIABA expressed support for the reasonable basis requirement, stating that there must be a "reasonable basis for all assumptions, conclusions, and recommendations." On the other hand, SIFMA suggested that FINRA remove the proposed reasonable basis

---

29 See ABA, ICI, SIFMA.

30 See 15 U.S.C. 80a-2(a)(51)(A) and 17 CFR 270.3c-5(a)(4), respectively. The "knowledgeable employee" definition in ICA Rule 3c-5 also refers to specified officers, directors, and employees of private funds relying on ICA section 3(c)(1). However, because Rules 5122 and 5123 do not exempt section 3(c)(1) funds that are sold to natural person accredited investors, a private offering sold to a knowledgeable employee of a 3(c)(1) fund generally would not be eligible for the exemptions from those rules.

requirement, noting that the IA Marketing Rule has no such requirement. Several commenters suggested that the reasonable basis requirement would be onerous, would overlap with other regulatory requirements, and that compliance would be practically difficult,[31] particularly if materials containing projections or targeted returns were prepared by the issuer, a difficulty that may be exacerbated if there is no control relationship between the issuer and the member.[32] According to some commenters, marketing materials are often drafted by the issuers and, as a result, members may have difficulty establishing a reasonable basis for the criteria used and assumptions made in calculating the projected performance or targeted return.[33]

Monument Group suggested that it is unclear whether under the proposed rule change a broker-dealer must form and document its own reasonable basis for the projections and targets (which, it argues, would be a duplicative and burdensome process for an independent placement agent broker-dealer) or may rely on the fund sponsor who creates and supplies the projections and targets to the placement agent. In the case of third-party prepared marketing materials, SIFMA similarly stated that it should be reasonable for a broker-dealer to rely upon the certification or representations of the sponsor, manager or party calculating this information.

Some commenters stated that the recordkeeping requirement associated with the reasonable basis requirement would require access to and retention by the broker-dealer of materials that fund managers consider trade secrets,[34] and requested that FINRA clarify its expectations around the reasonable basis requirement and the associated recordkeeping obligation.[35] For example, Dechert suggested that the broker-dealer's "obligation should be (i) to establish a reasonable basis to believe that the criteria used and assumptions made in calculating the targeted return or projected performance are appropriate and not misleading, and (ii) retain written records supporting such reasonable basis." In the case of projections prepared by a third party, such as a fund manager, Dechert stated that FINRA should require records that demonstrate this testing process. These commenters suggested that the practical difficulties surrounding the reasonable basis and the associated

---

31 See ICI, Monument Group, SIFMA.

32 See Dechert.

33 See ICI, SIFMA.

34 See Dechert, Monument Group.

35 See Monument Group, SIFMA.

recordkeeping requirements may dissuade brokers from using projections, thereby diminishing the potential benefits of the proposal.[36]

Two commenters addressed the factors in the proposed Supplementary Material. ICI stated that these factors could be helpful but urged that compliance not be reduced to a formulaic box-checking exercise and recommended that FINRA be clear that its applicability and consideration and weighting of any factors will depend on the facts and circumstances of the communication. Monument Group suggested that the factors may create potentially overlapping, ambiguous and onerous requirements that could dissuade members from using performance projections and targets with investors.

FINRA appreciates these comments and continues to believe that the use of projections or targeted returns should be conditioned on, among other requirements, the member forming a reasonable basis for the criteria used and assumptions made in calculating projected performance or a targeted return. As noted in the rule filing, the "reasonable basis" requirement follows well-established precedents. Members are familiar with making reasonable basis determinations in, for example, the context of Rules 2210 and 2241 (Research Analysts and Research Reports), which require a price target in a research report to have a reasonable basis.[37] Similarly, issuers have reasonable basis requirements. For example, SEC rules require performance projections contained in specified documents to be based on good faith and have a reasonable basis.[38] Moreover, while the SEC's IA Marketing Rule does not contain an express reasonable basis requirement in its provision governing hypothetical performance, the rule's general prohibitions would prohibit including hypothetical performance for which the adviser does not have a reasonable basis in adviser advertising.[39]

As to practical application of the rule, FINRA notes that the proposed rule change does not prescribe the manner in which the member forms its reasonable basis. As in other contexts, members have flexibility to determine what is reasonable based upon the particular facts and circumstances. If a member is using communications that contain projections or targeted returns created by an issuer or other third party, the member would need to obtain enough information to form a reasonable basis as to the issuer's assumptions

---

36 See ICI, Monument Group, SIFMA.

37 See Rule 2210(d)(1)(F)(iii) and Rule 2241(c)(1)(B).

38 See Securities Act Regulation S-K, 17 CFR 229.10(b) (providing in part that the use in documents specified in Securities Act Rule 175 and Exchange Act Rule 3b-6 of management's projections of future economic performance have a reasonable basis and reflect its good faith assessment of a registrant's future performance).

39 See Advisers Act Rule 206(4)-1(a)(1) through (a)(7). See also infra note 45.

and the underlying criteria. If the member is unable to do so, it should refrain from using the communications.

FINRA disagrees with comments that members should be allowed to avoid having to independently determine if a projection or targeted return has a reasonable basis if an issuer or other third party created the projected performance. Rule 2210's content standards apply to communications "distributed or made available" to investors, regardless of whether the member created the communication. [40] Accordingly, FINRA applies Rule 2210's content standards to third-party prepared materials as well as materials prepared by a member.[41] It would be incongruous to allow members to avoid content standards applicable to projections and targeted returns, including the requirement that the projected performance has a reasonable basis, merely because a third party created the communication. In addition, FINRA believes that allowing members to avoid this responsibility increases the risk that unreasonable, issuer-created projections would be distributed to investors, which is contrary to the public interest.

IV. Written Policies and Procedures

The proposed rule change conditions the exception for the use of projections and targeted returns on, among others, the member adopting and implementing 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 and to ensure compliance with all applicable requirements and obligations. This requirement is substantially similar to a related provision in the IA Marketing Rule.[42]

Several commenters addressed this requirement in their comments. Three commenters suggested that this proposed condition, while substantially similar to the related provision in the IA Marketing Rule, is unnecessary.[43] These commenters argue that

---

40 See Rule 2210(a)(2), (3), and (4) (definitions of correspondence, retail communication, and institutional communication).

41 See Regulatory Notice 20-21 (July 2020) ("FINRA disciplinary actions demonstrate that member firms can be liable for violations of Rule 2210 when distributing or using noncompliant retail communications prepared by a third party") (citations omitted).

42 See Advisers Act Rule 206(4)-1(d)(6)(i) (prohibiting the use of hypothetical performance unless the IA "adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement").

43 See ABA, Dechert, Monument Group.

because the proposed rule change would limit the use of projections and targeted returns as a threshold matter to sophisticated investors (*i.e.*, institutional investors and QPs in connection with specified non-public offerings) and members would have policies and procedures reasonably designed to ensure that investors meet those classifications, that a further determination of investors' financial situation and investment objectives is unwarranted.[44] Monument Group suggested that the condition is redundant of existing suitability obligations under Rule 2111 and imposes obligations similar to those required for retail investors (*e.g.*, investor's investment portfolio, liquidity needs, risk tolerance), rather than those currently required by FINRA for institutional investors. Although ABA stated that this requirement is unnecessary, it requested that, if adopted, 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.

FINRA recognizes that, unlike the IA Marketing Rule, the proposed rule change expressly limits the use of projections and targeted returns to communications distributed or made available solely to certain categories of investors on the basis that these investors have the financial expertise to evaluate investments and to understand the assumptions and limitations associated with such projections, or have resources that provide them with access to financial professionals who possess this expertise. As discussed above, FINRA believes that this limitation is appropriate at this time.

Nevertheless, FINRA believes that the condition 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 important. In addition, FINRA notes that Rule 2210 and Rule 2111 (Suitability) are distinct rules with different scopes and objectives. While it is true that Rule 2111 and the SEC's Regulation Best Interest require a broker-dealer to consider an investor's investment profile (including, among other factors, investment objectives), 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. FINRA 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 Rule 2111 or Regulation Best Interest.

SIFMA suggested that FINRA clarify that members would be permitted to consider the *category* of investor, rather than an investor's individual characteristics, when ensuring that the communication is relevant to the investor. FINRA confirms that it intends to apply

---

44 Id.

this condition consistently with the substantially similar provision in the IA Marketing Rule.[45] As with the IA Marketing Rule, the proposed rule change 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 (emphasis added).[46] By using "likely," FINRA intends that a member is not required to know the actual financial situation or investment objectives of each investor that receives the communication. This term also permits members to comply with this condition by grouping investors into categories or types.

V. Backtested Performance, Extracted Performance and IRR

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. Monument Group and Dechert suggested that FINRA allow the use of backtested performance or the prior performance of a portfolio or model created solely for the purpose of establishing a track record as the basis for projected performance or targeted returns. These commenters stated that fund managers often establish model portfolio and seed accounts in advance of launching a new product or rely on backtesting to assess how investment portfolios would have performed under various market environments and suggested that the prohibition on backtested performance deviates from the IA Marketing Rule and limits the practical application of the proposed rule change.[47]

As FINRA noted in its rule filing, backtested performance is beyond the scope of the proposal's intent, and FINRA does not believe that members should be allowed to use backtested performance as a basis for projected performance or targeted returns. FINRA sees little difference between allowing members to use backtested performance as a basis for a projection or targeted return and allowing members to present backtested performance on its own.[48]

---

45 FINRA's proposed rule change does not interpret the SEC's IA Marketing Rule and nothing in the proposed rule change should be construed as impacting the application or interpretation of the SEC's rule.

46 See Advisers Act Rule 206(4)-1(d)(6)(i).

47 See Dechert, Monument Group.

48 See, e.g., Letter from Joseph E. Price, FINRA, to Bradley J. Swenson, Chief Compliance Officer, ALPS Distributors, Inc., dated April 22, 2013, https://www.finra.org/rules-guidance/guidance/interpretive-letters/bradley-j-

FINRA's proposed rule change focuses on communications with projections of performance and targeted returns, and is, therefore, narrower than the SEC IA Marketing Rule's hypothetical performance standard, which includes targeted or projected performance as well as performance that is backtested by the application of a strategy to data from prior time periods when the strategy was not actually used during those time periods.[49]

While FINRA has endeavored to align, where appropriate, the conditions the SEC applies to hypothetical performance under its IA Marketing Rule, FINRA has not attempted to make the proposed rule change fully congruent with that rule, including the types of performance covered. As such, we are not including backtested performance in the scope of this rulemaking. FINRA's experience generally is that backtested performance may pose an increased risk for misleading investors, as it allows hypothetical investment decisions to be optimized by hindsight. Therefore, FINRA is not proposing to further amend Supplementary Material 2210.01(b) in this regard, as originally proposed.

Extracted Performance

Dechert suggested that FINRA align the treatment of extracted performance under Rule 2210 with the IA Marketing Rule and the Private Fund Adviser Rules. Specifically, Dechert stated that FINRA's previous guidance,[50] which provides that the performance of an unrealized holding would represent a prohibited projection under Rule 2210, is inconsistent with the SEC's treatment of extracted performance under the IA Marketing Rule.[51] As a result, Dechert stated that this performance information may be distributed to

---

swenson-alps-distributors-inc (declining to object to the use of pre-inception index performance ("PIP" data) in institutional communications, in the circumstances presented, but noting that the interpretation does not affect FINRA's long standing position that the presentation of hypothetical back tested performance in communications used with retail investors does not comply with Rule 2210(d)); see also Letter from Joseph P. Savage, FINRA, to Meredith F. Henning, Foreside, dated January 31, 2019, https://www.finra.org/rules-guidance/guidance/interpretive-letters/interpretive-letter-meredith-f-henning-foreside.

49 See Advisers Act Rule 206(4)-1(e)(8) (defining "hypothetical performance").

50 Specifically, Dechert cites FINRA FAQ D.6.2.

51 See Dechert (citing SEC Staff's Marketing Compliance Frequently Asked Questions guidance that the performance of individual holdings (realized or unrealized) would be treated as "extracted performance" under the IA Marketing Rule).

the general public by an adviser under the IA Marketing Rule, subject to certain conditions, but could only be shared with a limited audience by a broker-dealer under FINRA's proposed rule change. Similarly, Dechert noted that 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 IA Marketing Rule but is prohibited by FINRA guidance.

FINRA's proposed rule change would allow communications used with institutional investors and QPs and knowledgeable employees, in the manner discussed above, to display the performance of unrealized holdings subject to the requirements of the proposed rule. While Dechert noted that such performance may only be shared with this limited audience, that is also the case for all communications that meet the requirements of the proposed rule. FINRA continues to believe that extracted performance concerning unrealized holdings may pose an increased risk for misleading retail investors who are not eligible to receive projections under the proposed rule change, as such investors may not have the financial expertise to evaluate investments and to understand the limitations associated with the performance of unrealized holdings or have the resources that would provide them with access to financial professionals who possess this expertise.

Internal Rates of Return ("IRR")

Several commenters requested clarity on the treatment of IRR, citing FINRA's guidance in Regulatory Notice 20-21, which states that use of IRR in retail communications concerning privately placed new investment programs that have no operations or that operate as a blind pool would be inconsistent with the prohibition of unwarranted forecasts or projections in Rule 2210(d)(1)(F).[52] Dechert commented that, to the extent that FINRA is seeking to align its performance standards with the Marketing Rule, Global Investment Performance Standards ("GIPS"), and general industry standards, FINRA should provide guidance that the 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. SIFMA requested that FINRA confirm that the proposed rule change would modify previous guidance on IRR, permitting the use of IRRs for new private funds and unrealized holdings within a fund. Monument Group stated that IRR is an important metric to fund managers and institutional investors and any lack of clarity as to members' use of IRRs puts placement agent broker-dealers at a competitive disadvantage to private fund managers. ABA stated that the FINRA's guidance deviates from the SEC's IA Marketing Rule, which does not include GIPS, and requested that FINRA clarify that – with respect to the retail investors that may receive communications with projections pursuant to the proposal (*i.e.*, QPs in connection with specified non-public

---

52 See ABA, Dechert, Monument Group, SIFMA; see also Regulatory Notice 20-21 (July 2020).

offerings) – members would be allowed to use non-GIPS compliant historical IRR with unrealized components.

The guidance in Regulatory Notice 20-21 that IRR be calculated in a "manner consistent with the Global Investment Performance Standards (GIPS)" refers to using the same primary inputs and calculation methodology articulated in the GIPS standards as well as including prominently in the communication the additional required metrics set forth in the GIPS standards. Members are not required to claim compliance with GIPS or choose to have their firm verified in order to use IRR in private placement communications in a manner that is consistent with the requirements of Rule 2210.[53]

The proposed rule change would permit the use of IRR for new private funds and for unrealized holdings within a fund in communications used with institutional investors and QPs and knowledgeable employees, in the manner discussed above and subject to the requirements of the proposed rule change. Similarly, members could use non-GIPS compliant IRR, including unrealized components, with retail investors who are eligible to receive projections under the proposed rule change.[54] The guidance provided in Regulatory Notice 20-21 would continue to be applicable to communications used with retail investors who are not eligible to receive projections under the proposed rule change.

VI. Other Requested Guidance

SIFMA asked FINRA to confirm that members may use projections relevant to the time horizon of the investment. As noted above, the proposal would require a member to have a reasonable basis for a projection of performance or targeted return. 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. Moreover, an investment's time horizon often is uncertain at the time a security is issued and may change due to subsequent events. 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.

---

53 See, e.g., CFA Institute, Global Investment Performance Standards (GIPS) For Verifiers (2020) (discussing GIPS verification), https://www.gipsstandards.org/wp-content/uploads/2021/03/2020_gips_standards_verifiers.pdf.

54 See supra note 15.

Attachment A: Alphabetical List of Commenters to File No. SR-FINRA-2023-016

1. Bernard V. Canepa, Securities Industry and Financial Markets Association ("SIFMA") (December 15, 2023)

2. Anya Coverman, Institute for Portfolio Alternatives ("IPA") (December 15, 2023)

3. Molly Diggins, Monument Group, Inc. ("Monument Group 1") (December 13, 2023)

4. Molly Diggins, Monument Group, Inc. ("Monument Group 2") (January 31, 2024)

5. Dorothy M. Donohue & Matt Thornton, Investment Company Institute ("ICI") (December 15, 2023)

6. Jay H. Knight, American Bar Association Business Law Section, Federal Regulation of Securities Committee ("ABA") (January 8, 2024)

7. Jacqueline Kuiper, Nelson Kuiper PLLC ("Nelson Kuiper") (December 15, 2023)

8. Michael McGrath & Lindsay Grossman, Dechert LLP ("Dechert") (December 15, 2023)

9. Joseph C. Peiffer, Public Investors Advocate Bar Association ("PIABA") (December 15, 2023)

10. Mike Underhill, Alternative & Direct Investment Securities Association ("ADISA") (December 15, 2023)