



## FINRA'S Proposed Rules 2210 and 2211

As part of its continuing effort to create a consolidated rulebook, the Financial Industry Regulatory Authority, Inc. ("FINRA") has proposed a new FINRA Rule 2210 that would subsume, subject to certain changes, the provisions of current NASD Rules 2210 and 2211, NASD Interpretive Materials 2210-1 and 2210-4, and the provisions of Incorporated NYSE Rule 472 that do not pertain to research analysts and research reports (collectively, the "Proposal"). The following client alert provides a brief analysis of some of the significant proposed changes.

### Communications Categories

#### *Current Communications Categories*

Currently, NASD Rule 2210 divides communications into the following six categories:

- An "advertisement" includes written (including electronic) retail communications that do not have a limited audience, such as newspaper, magazine, television and radio advertisements, billboards and websites.
- "Sales literature" includes written (including electronic) retail communications that have a more targeted audience, such as brochures, performance reports, telemarketing scripts, seminar scripts and form letters.
- "Correspondence" includes written letters, electronic mail, instant messages and market letters sent to one or more existing retail customers or fewer than 25 prospective retail customers within a 30-calendar-day period.
- "Institutional sales material" includes communications that are distributed or made available only to institutional investors.
- An "independently prepared reprint" includes reprints of articles from independent publications, as well as reports published by independent research firms.
- A "public appearance" includes unscripted participation in live events, such as interviews, seminars and call-in television and radio shows.

Historically, FINRA has applied differing approval, filing and content standards to each category of communications above. The filing requirements also differ based on the type of member using the material and the contents of the communication.

### *Revised Communications Categories*

The Proposal would reduce the types of communication categories from six to three, as follows:

- An “institutional communication” would include any written (including electronic) communication that is distributed or made available only to institutional investors.
- A “retail communication” would include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period.
- “Correspondence” would include any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30-calendar-day period.

Communications that currently qualify as an advertisement, sales literature or an independently prepared reprint to more than 25 retail investors within a 30-calendar-day period would each now generally be classified as a retail communication. Communications that are currently categorized as institutional sales material would be classified as institutional communications. Some communications that currently qualify as “correspondence,” if sent to more than 25 retail investors within a 30-calendar-day period, would be considered retail communications.

### **Approval, Review and Recordkeeping Requirements**

#### *Approval and Review*

Currently, NASD Rule 2210(b)(1)(A) requires a registered principal of the member to approve each advertisement, item of sales literature and independently prepared reprint before the earlier of its use or filing with FINRA. Under the Proposal, an appropriately qualified registered principal of the member would be required to approve each retail communication. The principal registration required to approve particular communications would depend upon the permissible activities for each principal registration category.

The Proposal would continue to require that research reports on debt and equity securities be approved by a Series 16 supervisory analyst and would maintain the exception from the principal approval requirements for an advertisement, item of sales literature, or independently prepared reprint, if at the time that a member intends to publish or distribute it: (i) another member 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 member has not materially altered it and will not use it in a manner that is inconsistent with the conditions of FINRA’s letter.

The Proposal would carve out three additional categories of retail communications from the approval requirements, provided that the member supervises and reviews the communications in the same manner as required for supervising and reviewing correspondence pursuant to NASD Rule 3010(d). These communications include:

- Any retail communication that does not fall under the definition of “research report” pursuant to NASD Rule 2711(a)(9)(A);
- Any retail communication that is posted on an online interactive electronic forum; and
- Any retail communication that does not contain a financial or investment recommendation or otherwise promote a product or service of the member.

The Proposal would also allow FINRA to grant an exemption from the principal approval requirements above, provided that the exemption is consistent with the goals of protecting investors and the public interest.

Proposed FINRA Rule 2210(b)(1)(F) would require that an appropriately qualified principal approve any communication that is filed with FINRA, even if a communication would otherwise come under an exception to the principal approval requirements of proposed FINRA Rule 2210(b)(1)(A).

### *Recordkeeping*

NASD Rule 2211(b)(2) requires members to maintain records of institutional sales material for a period of three years from the date of last use, including the name of the person who prepared each such communication. NASD Rules 3010(d)(3)18 and 3110(a)19 require members to retain correspondence of registered representatives as prescribed by Securities Exchange Act Rule 17a-4.

Proposed FINRA Rule 2210(b)(4)(A) specifies that the records for retail and institutional communications would have to 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 of the approval;
- In the case of a retail communication or 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 retail communications that rely on the exception under proposed FINRA Rule 2210(b)(1)(C), the name of the member that filed the retail communication with FINRA and a copy of FINRA's review letter.

## **Filing Requirements and Review Procedures**

### *Filing of Initial Communications*

Currently, NASD Rule 2210(c)(5)(A) requires a member that has not previously filed advertisements with FINRA or another self-regulatory organization to file its initial advertisement with FINRA at least 10 business days prior to use. This filing requirement continues for a year after the initial filing. Proposed FINRA Rule 2210(c)(1)(A) would trigger the new member one-year filing requirement beginning on the date that the firm's FINRA membership became effective in FINRA's Central Registration Depository, rather than on the date a member first files an advertisement with FINRA.

### *Filing Requirement for Delinquent Members*

NASD Rule 2210(c)(5)(B) currently authorizes FINRA to require a member to file all of its advertisements and/or sales literature, or the portion of the member's material relating to specific types or classes of securities or services, with FINRA at least 10 business days prior to use, if FINRA determines that the member has departed from NASD Rule 2210's standards. Proposed FINRA Rule 2210(c)(1)(B) would carry forward this authority and apply it to all of a member's communications (rather than just advertisements or sales literature).

### *Pre-use Filings and Clearance*

NASD Rule 2210(c)(4) currently requires members to file certain communications at least 10 business days prior to first use and to withhold them from use until any changes specified by FINRA have been made. These communications include advertisements and sales literature for certain registered investment companies that include self-created rankings, advertisements concerning CMOs, and advertisements concerning security futures.

Proposed FINRA Rule 2210(c)(2) would revise the categories of communications that fall within this pre-use filing requirement. These include retail communications concerning any registered investment company that include self-created rankings, retail communications concerning security futures, and retail communications that include bond mutual fund volatility ratings.

The requirement to file retail communications concerning security futures prior to first use would not apply to retail communications that are submitted to another self-regulatory organization having comparable standards pertaining to such communications, and retail communications in which the only reference to security futures is contained in a listing of the services of a member.

#### *Filings Within 10 Days of First Use*

Proposed FINRA Rule 2210(c)(3) would revise the categories of communications that must be filed within 10 business days of first use or publication. FINRA Rule 2210(c)(3) would require the following communications to be filed within 10 business days of first use or publication:

- Retail communications concerning registered investment companies and public direct participation programs (including all retail communications concerning closed-end registered investment companies);
- All retail communications concerning government securities;
- Templates for written reports produced by, or retail communications concerning, an investment analysis tool;
- Retail communications concerning CMOs that are registered under the Securities Act of 1933 (“Securities Act”); and
- All retail communications concerning any security that is registered under the Securities Act 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.

Consistent with current rules, if a member has filed a draft version or “story board” of a television or video retail communication pursuant to a filing requirement, then the member must also file the final filmed version within 10 business days of first use or broadcast.

### **Content Standards**

The Proposal generally follows the content standards of NASD Rule 2210, with a few important differences. Content standards that currently apply to advertisements and sales literature would generally also apply to retail communications.

#### *Promissory Claims*

Proposed FINRA Rule 2210(d)(1)(B) would expressly prohibit promissory statements or claims.

#### *Projections*

Proposed FINRA Rule 2210(d)(1)(F) would carry forward the current prohibition of performance predictions and projections, as well as the permitted use of hypothetical illustrations of mathematical principles. The Proposal would also clarify that FINRA allows two additional types of projections of performance in communications with the public that are not reflected in the text of NASD Rule 2210(d)(1)(D):

- Projections of performance in reports produced by investment analyst tools that meet the requirements of NASD IM-2210-6 (to be codified under the Proposal as FINRA Rule 2214); and
- Research reports on debt or equity securities, including price targets under certain circumstances.

### *Price Targets*

Proposed FINRA Rule 2210(d)(1)(F) also would clarify that it does not prohibit a price target contained in a research report on debt or equity securities, provided that the price target has a reasonable basis, the report discloses the valuation methods used to determine the price target, and the price target is accompanied by disclosure concerning the risks that may impede achievement of the price target.

### *Identity of Member*

NASD Rule 2210(d)(2)(C) requires all advertisements and sales literature to:

- Prominently disclose the name of the member, and allows a fictional name by which the member is commonly recognized or which is required by any state or jurisdiction;
- Reflect any relationship between the member and any non-member or individual who is also named in the communication; and
- If the communication includes other names, reflect which products and services are offered by the member.

These standards would apply to correspondence as well as to retail communications.

Members would be permitted to use the name under which a member's broker-dealer business is conducted as disclosed on the member's Form BD, as well as a fictional name by which a member is commonly recognized or which is required by any state or jurisdiction.

### *Disclosure of Tax Aspects of Investments*

The Proposal would carry forward the current required disclosures concerning applicable taxes and the current prohibition on communications with the public that characterize income or investment returns as tax-free or exempt from income tax when tax liability is merely postponed or deferred.

Proposed FINRA Rule 2210(d)(4)(C) would add new language concerning comparative illustrations of the mathematical principles of tax-deferred versus taxable compounding. Such illustration:

- Must depict both the taxable investment and the tax deferred investment using identical investment amounts and identical assumed gross investment rates of return, which may not exceed 10 percent per annum;
- Must use and identify actual federal income tax rates;
- Would be permitted (but not required) to reflect an actual state income tax rate, provided that the communication prominently discloses that the illustration is applicable only to investors that reside in the identified state;
- Should refer to tax rates that reasonably reflect those of the target audience as well as the tax character of capital gains and ordinary income;
- Would have to reflect the impact of taxes during this period;

- Could not assume an unreasonable period of tax deferral; and
- Would have to include the following disclosures, as applicable:
  - The degree of risk in the investment's assumed rate of return, including a statement that the assumed rate of return is not guaranteed;
  - The possible effects of investment losses on the relative advantage of the taxable versus tax-deferred investments;
  - The extent to which tax rates on capital gains and dividends would affect the taxable investment's return;
  - Its underlying assumptions;
  - The potential impact resulting from federal or state tax penalties; and
  - That an investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision.

#### *Communications that Contain a Recommendation*

Proposed FINRA Rule 2210(d)(7) would revise in several ways the standards currently found in NASD IM-2210-1(6) applicable to communications that contain a recommendation, and extend the application of these standards to retail communications and public appearances.

Currently, NASD IM-2210-1(6)(A) requires disclosure of certain specified conflicts of interest:

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

Proposed FINRA Rule 2210(d)(7)(A) would continue the first and third disclosures, but would modify the second disclosure to limit it to financial interests of the member or any associated person with the ability to influence the content of the communication, unless the extent of the financial interest is nominal.

Proposed FINRA Rule 2210(d)(7)(D) would expressly exclude from its coverage communications that meet the definition of "research report" or that are public appearances by a research analyst for purposes of NASD Rule 2711 and that include all of the applicable disclosures required by that rule. Proposed FINRA Rule 2210(d)(7)(D) would also exclude any communication that recommends only registered investment companies or variable insurance products.

#### *Public Appearances*

In the interest of simplification, the term "public appearance" is no longer a separate communication category. Nevertheless, proposed FINRA Rule 2210(f) sets forth many of the same general standards that would apply to public appearances that exist currently. Public appearances would have to meet the "fair and balanced" standards of proposed paragraph (d)(1). Unlike the current rules governing public appearances, the disclosure requirements applicable to recommendations in proposed paragraph (d)(7) also would apply if the public appearance included a recommendation of a security. Members would also be required to establish appropriate written policies and

procedures to supervise public appearances, and scripts, slides, handouts or other written (including electronic) materials used in connection with public appearances.

### **Use of Investment Company Rankings in Retail Communications**

Proposed FINRA Rule 2212 would replace NASD IM-2210-3 with regard to standards applicable to the use of investment company rankings in communications, with few changes.

FINRA has revised the standards applicable to investment company rankings for more than one class of an investment company with the same portfolio. Such rankings must also be accompanied by prominent disclosure of the fact that the investment companies or classes have different expense structures. The Proposal would add a new paragraph (h) that would exclude from the proposed rule's coverage reprints or excerpts of articles or reports that are excluded from FINRA's filing requirements.

### **Requirements for the Use of Investment Analysis Tools**

Proposed FINRA Rule 2214 would replace NASD IM-2210-6 with regard to standards applicable to the use of investment analysis tools. The standards would generally remain the same with some minor changes.

#### *Review of Investment Analysis Tools*

Proposed FINRA Rule 2214(a) would require members to provide FINRA with access to any investment analysis tool and to file any template for written reports produced by, or any retail communication concerning, the tool within 10 business days of first use. This revision makes the access and filing time frame consistent with other filing requirements under proposed FINRA Rule 2210(c).

#### *Supplemental Materials*

Under the Proposal, the rule's Supplemental Material would provide:

- A retail communication that contains only an incidental reference to an investment analysis tool would not have to include the disclosures otherwise required for retail communications that advertise an investment analysis tool, and would not have to be filed.
- If a retail communication refers to an investment analysis tool in more detail but does not provide access to the tool or the results generated by the tool, the communication would only have to include the disclosures required by paragraphs (c)(2) and (c)(4) of proposed FINRA Rule 2214.
- Members are required to disclose whether the analysis tool is limited to searching, analyzing or in any way favoring securities in which the member serves as an underwriter.

### **Communications with the Public Regarding Security Futures**

Proposed FINRA Rule 2215 would replace NASD IM-2210-7 with regard to standards applicable to communications concerning security futures and would apply these provisions to all retail communications, not just advertisements.

Proposed FINRA Rule 2215(a)(1) would require members to submit all retail communications concerning security futures to FINRA at least 10 business days prior to first use.

The Proposal would amend the provisions that require communications concerning security futures to be accompanied or preceded by the security futures risk disclosure document under certain circumstances. As revised, a communication concerning security futures would have to be accompanied or preceded by the risk disclosure document if it contains the names of specific securities.

The Proposal would clarify that communications that contain the historical performance of security futures must disclose all relevant costs, which must be reflected in the performance.

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