FINRA Releases Additional Guidance Regarding the Use of Pre-Inception Index Performance in Institutional Communications

May 2, 2013

On April 22, 2013, the Financial Industry Regulatory Authority ("FINRA") issued an **Interpretive Letter** to ALPS Distributors, Inc. setting forth guidance regarding the use of pre-inception index performance ("PIP") data for exchange-traded products ("ETPs") in institutional communications.

Background

PIP data (also known as "back tested" or "hypothetical" data) is often used to model the performance of a proprietary index prior to its actual launch date, particularly in the case of indices that lack a lengthy record of actual historical performance. This information can show how an index would have performed under different market conditions in the past and help an investor understand how a particular investment might fit into an investment strategy or portfolio.

Key Criteria

The Interpretive Letter authorizes member firms to distribute PIP data with respect to an index, but only to "institutional investors,"[1] only to market passively managed ETPs and only if it meets certain criteria. FINRA's guidance "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 FINRA Rule 2210(d)."

PIP data must reflect performance "during a period of time that includes multiple securities markets environments, and at a minimum, ten years since the inception of the index," and be current as of the most recently ended calendar quarter. It must also be "clearly labeled and presented separately from actual performance" data, with applicable dates disclosed. If the ETP has been in existence for more than one year, it must be accompanied by actual performance of the ETP, prominently presented. The presentation of the PIP data (and any such actual data) must also "reflect the deduction of fees and charges applicable to the ETP."

Other Requirements

The index must have been created according to a pre-defined set of rules that cannot be altered except under extraordinary market conditions, and the rule set or methodology of the index must be made available. The identity of and arrangements with any index provider that has been paid to provide the PIP data must also be disclosed.

PIP data must also be accompanied by disclosure required to meet the content standards of FINRA Rule 2210(d), as well as other specific disclosures relating to its inherent limits and characteristics relating to its

[1] As defined in FINRA Rule 2210(a)(4), an "institutional investor" is generally a financial institution, registered investment advisor, person (natural or otherwise) with assets of at least $50 million, governmental entity, certain employee benefit and pension plans, a FINRA member, or any person acting solely on behalf of any such institutional investor.

hypothetical nature. Any "known reasons why the PIP data would have differed from actual performance during the period shown" must also be disclosed; FINRA uses as examples assumptions regarding transaction costs, liquidity or other market factors. Any marketing materials including PIP data must be clearly labeled: "For use with institutions only, not for use with retail investors."

Considerations for Member Firms

FINRA also identified a number of factors for member firms to consider when determining whether to use PIP data in institutional communications. These include the source of the data used to produce the PIP data, the reputation of its creator and how any material conflicts of interest have been addressed or mitigated. Member firms should also review the assumptions, rules and criteria used to create the PIP data, in sufficient detail to permit the firm to clearly understand how the PIP data could be replicated using readily available market data. Other considerations include the extent to which the PIP data has been tested under varying market conditions and conditions that could limit the predictive function of the PIP data.

FINRA also said that, in applying suitability standards for investor recommendations, member firms must be careful not to "give excess weight to PIP data," and "to the extent PIP data informs the firm's understanding of the security and its performance characteristics, the firm must consider the correlation between PIP data and actual performance for similar ETPs managed by the sponsor, investment adviser or index provider."

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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