

SEC Approves Amendments to FINRA Communications Rules

April 18, 2012

The Securities and Exchange Commission has approved a significant overhaul of FINRA's rules governing members' communications with customers and the public.¹ The revised communication rules will simplify and reorganize existing rules by reducing the number of communications categories from six to three. The new rules will also implement some noteworthy changes, such as the requirement to file with FINRA within 10 days of first use retail communications relating to registered structured products.

FINRA will publish a Regulatory Notice by June 27, 2012 announcing an implementation date for the new rules that is not later than March 29, 2013. FINRA acknowledges that members will need time to alter their internal policies and procedures in response to the new requirements, and has stated it will take this into consideration in establishing an implementation schedule.

The final rule would create a new FINRA Rule 2210 called "Communications with the Public" that incorporates NASD Rules 2210 and 2211, related NASD Interpretive Materials, as well as portions of Incorporated NYSE Rule 472, and also create new FINRA Rules 2212 to 2216 that incorporate certain Interpretive Materials that currently follow NASD Rule 2210.²

New Communications Categories

The existing rules apply different requirements to six distinct categories of communications. The new rules will combine these six categories into three categories of communications, as follows:

- **Retail Communications**, which include any written, including electronic, communication that is distributed or made available to more than 25 retail investors³ within any 30 calendar-day period.
- **Institutional Communications**, which include any written, including electronic, communication that is distributed or made available only to institutional investors, but does not include a member's internal communications.⁴
- **Correspondence**, which includes any written, including electronic, communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period.

¹ Exchange Act Release No. 66681, 77 FR 20452 (April 4, 2012). FINRA first proposed to amend these rules in 2009 and proposed three subsequent amendments.

² **FINRA Rule 2212** ("Use of Investment Companies Rankings in Retail Communications"); **FINRA Rule 2213** ("Requirements for the Use of Bond Mutual Fund Volatility Ratings"); **FINRA Rule 2214** ("Requirements for the Use of Investment Analysis Tools"); **FINRA Rule 2215** ("Communications with the Public Regarding Securities Futures"); and **FINRA Rule 2216** ("Communications with the Public About Collateralized Mortgage Obligations").

³ "Retail investor" means any person other than an institutional investor, regardless of whether the person has an account with a member. "Institutional investor" includes a bank, savings and loan association, insurance company, registered investment company, SEC or state registered investment adviser, natural person or entity with total assets of at least \$50M, government entity, certain employee benefit plans with at least 100 participants (but not any participant of such plans), FINRA members and their registered persons, and any person acting solely on behalf of an institutional investor.

⁴ Consistent with its historic practice, FINRA had proposed to include within the definition of "institutional communications" internal written communications by members that are intended to educate or train registered representatives about the members' products or services, but ultimately backed away from this position. However, FINRA notes in the adopting release that such internal communications would be governed by NASD Rule 3010 ("Supervision").

The following chart compares the old and new categories of communications:

Existing Category	Under NASD Rules 2210/2211	Under New FINRA Rule 2210
<i>Advertisement</i>	Communication with the public that appears in media, such as a newspaper, radio, television or website.	Would generally be considered <u>retail communications</u> .
<i>Sales literature</i>	Communication directed at a specific audience, such as mailers and brochures.	Would generally be considered <u>retail communications</u> .
<i>Institutional sales material</i>	Communication only distributed or made available to institutional investors.	Would generally be considered <u>institutional communications</u> .
<i>Correspondence</i>	Written communication for delivery to one or more current retail customers and less than 25 prospective retail customers within a 30-day period.	May be either <u>correspondence</u> or <u>retail communications</u> . New “correspondence” category would not distinguish between existing or prospective customers and would be limited to communications distributed or made available to 25 or fewer retail investors.
<i>Public appearance</i>	Participation in a seminar, radio or television interview or other public speaking.	Category is eliminated but public appearances remain subject to general content standards in paragraph (d)(1) and the requirements in paragraph (f) of FINRA Rule 2210.
<i>Independently prepared reprint</i>	Reprint of an article issued by a publisher that is not affiliated with, and the article was not commissioned by, any of the FINRA member, the issuer, or an underwriter of securities mentioned in the article.	Category is eliminated; this type of material would remain excluded from filing requirements.

Institutional Communications: “Reason to Believe” Standard

FINRA Rule 2210 states that a member may not treat a communication as having been distributed to an institutional investor if the member has reason to believe that the communication will be forwarded or made available to a retail investor. FINRA Rule 2210 does not impose an affirmative obligation to inquire whether an institutional communication will be forwarded to retail investors every time such a communication is distributed. However, firms should maintain policies and procedures that are reasonably designed to ensure that institutional communications are not provided to retail investors. Legends that are intended to limit the communication’s distribution may be part of such policies and procedures, but legends alone are not sufficient. Firms should consider, for example, obtaining periodic assurances from institutional investors that they will not forward communications to retail investors. FINRA will provide in its forthcoming Regulatory Notice concerning the adoption of the new communication rules more guidance concerning the obligations of mutual fund underwriters in regard to other broker-dealers to whom they provide institutional communications.

Principal Approval and FINRA Advertising Department Filing

The existing rules impose different levels of principal approval and filing requirements for each category of communication. The new rules generally follow this existing regime, as modified for the new communication categories, with certain noteworthy changes. The table below summarizes the principal

pre-approval and filing requirements under new FINRA Rule 2210. Significant changes from the existing rules are noted in ***bolded italics***.

Requirement	Retail Communication	Institutional Communication	Correspondence
<i>Principal Pre-Approval</i>	<p>An <i>appropriately qualified</i> registered principal of the member must approve <i>each retail communication</i> before the earlier of use or filing with the FINRA Advertising Regulation Department.⁵</p> <p>Note: In light of FINRA Regulatory Notice 10-52, certain broadly disseminated free-writing prospectuses are subject to the principal review requirement.</p> <p>The new rules adopt three new exceptions to the principal pre-approval requirements:</p> <ul style="list-style-type: none"> ▪ <i>market letters (communications that are excepted from the definition of “research report” in NASD Rule 2711(a)(9)(A)) that do not make financial or investment recommendations;</i> ▪ <i>communications posted in an online interactive electronic forum; and</i> ▪ <i>retail communications that do not make any financial or investment recommendations or otherwise promote a product or service of the member.</i> 	<p>Written procedures must be established for principal review of institutional communications.</p> <p>If procedures do not require principal pre-approval, they must include a provision for training and education of associated persons as to the firm’s institutional communications procedures.</p>	<p>All correspondence is subject to the supervision and review requirements of NASD Rule 3010(d), which includes the development of appropriate procedures for the registered principal review and approval of correspondence.</p>
<i>Filing with FINRA Advertising Department: New Members</i>	<p><i>For the first year of FINRA membership</i>, firms must file any retail communication that is used in any electronic or other public media with FINRA at least 10 days prior to first use. <i>Free writing prospectuses that have been filed with the SEC may be filed within 10 business days of first use, rather than prior to first use.</i></p>	<p>Institutional communications are not required to be filed.</p>	<p>Correspondence is not required to be filed.</p>
<i>Filing with FINRA Advertising Department: Filings 10 Days Prior to First Use</i>	<p>Unless an exception applies, <i>all retail communications concerning the following</i> (not just advertising and sales materials, as required under the current rule) must be filed with FINRA 10 days prior to first use and withheld from publication or circulation until any required changes have been made:</p> <ul style="list-style-type: none"> ▪ registered investment companies that include performance rankings or comparisons of the investment company with other investment companies, when the ranking or comparison is not generally published, or is the creation of the investment company or its underwriter or affiliate; ▪ security futures, with certain exceptions; and ▪ bond mutual funds that include bond mutual fund volatility ratings. <p>Note: Advertisements concerning collateralized mortgage obligations no longer need to be filed prior to first use.</p>	<p>Institutional communications are not required to be filed.</p>	<p>Correspondence is not required to be filed.</p>

⁵ An NYSE approved supervisory analyst may approve certain research reports and communications that do not meet the requirements of a “research report” under NASD rules, if the supervisory analyst has technical expertise in the product area.

Requirement	Retail Communication	Institutional Communication	Correspondence
<p><i>Filing with FINRA Advertising Department: Filings Within 10 Days of First Use or Publication</i></p>	<p>Unless an exception applies, all retail communications concerning the following must be filed with FINRA within 10 days of first use or publication:</p> <ul style="list-style-type: none"> ▪ registered investment companies, if the communication is not required to be filed prior to first use; ▪ public direct participation programs; ▪ templates for written reports produced by or concerning an investment analysis tool; ▪ collateralized mortgage obligations; ▪ registered structured products that are derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency; ▪ television or video retail communications where the member has filed with FINRA a draft version of a “story board”. <p>Note: Advertisements concerning government securities no longer need to be filed.</p>	<p>Institutional communications are not required to be filed.</p>	<p>Correspondence is not required to be filed.</p>
<p><i>Filing with FINRA Advertising Department: Exclusions from Filing Requirement</i></p>	<p>The following retail communications are excluded from the filing requirement:</p> <ul style="list-style-type: none"> ▪ communications that have been previously filed and are to be used without material change; ▪ communications based on previously filed templates the changes to which are limited to updates of more recent statistical or other non-narrative information (Note: this is a codification of a 2002 interpretive letter); ▪ communications that do not make financial or investment recommendations; ▪ communications that only identify a member’s national securities exchange symbol or identify a security for which the member is a market maker and communications that do no more than identify the member or offer a specific security at a stated price; ▪ prospectuses, preliminary prospectuses, fund profiles, offering circulars, and similar documents that have been filed with the SEC or any state, except that the following communications: (i) an investment company prospectus published pursuant to Securities Act 482; and (ii) a free writing prospectus that is filed with the SEC pursuant to Exchange Act Rule 433(d)(ii) <u>will not be</u> considered a prospectus for purposes of this exclusion; ▪ Communications prepared in accordance with Section 2(10)(b) of the Securities Act or any rule thereunder, and announcements that a member has participated in a private placement, unless the communications are related to publicly offered direct participation programs or securities issued by registered investment companies; ▪ press releases and independently prepared reprints; 	<p>Institutional communications are not required to be filed.</p>	<p>Correspondence is not required to be filed.</p>

Requirement	Retail Communication	Institutional Communication	Correspondence
	<ul style="list-style-type: none"> ▪ correspondence and institutional communications; ▪ communications that refer to types of investments solely as a part of listing products or services offered by the member; ▪ communications that are posted on an online interactive forum; and ▪ press releases issued by closed-end investment companies that are listed on the New York Stock Exchange. 		

Content Standards

The new rules reorganize, but generally follow, the content standards in the existing rules, while codifying certain existing interpretations. As is the case under the existing rules, the content standards in new FINRA Rule 2210 require various disclosures in communications that include comparisons, tax considerations, testimonials and recommendations. The table below summarizes the content standards under the new rules. Significant changes from the existing rules are noted in ***bolded italics***.

Requirement	Retail Communication	Institutional Communication	Correspondence
<p><i>Content Standards:</i> General</p>	<p>Communications must be based on principles of fair dealing and good faith, be fair and balanced, provide a sound basis for evaluating the facts, and must not omit any material fact if the omission would make the communication misleading.</p> <p>Communications may not contain false or misleading statements or any statement which a member knows to be untrue.</p> <p>Information may be contained in footnotes or legends within the communication so long as they do not inhibit an investor's understanding.</p> <p>Communications must be clear and not misleading within the context in which they are made, must provide balanced treatment of risks and potential benefits. They must also be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments.</p> <p>Members must consider the nature of the audience to which the communication will be directed, and provide appropriate details and explanations.</p> <p>Communications must not predict or project performance; exceptions to this rule include hypothetical illustrations of mathematical principles, <i>investment analysis tools or written reports produced by them and a price target contained in a research report on debt or equity securities, in each case, subject to certain conditions.</i></p>	<p>Same as standard for retail communication.</p>	<p>Same as standard for retail communication.</p>
<p><i>Content Standards:</i> Comparisons</p>	<p>Any comparison between investments or services must disclose all material differences.</p>	<p>No applicable standard.</p>	<p>No applicable standard.</p>

Requirement	Retail Communication	Institutional Communication	Correspondence
<p><i>Content Standards:</i> Disclosure of Members' Name</p>	<p>All retail communications (other than "blind" advertisements used to recruit personnel) must:</p> <ol style="list-style-type: none"> 1. prominently disclose the member's name (<i>or the name under which the member's broker-dealer business primarily is conducted, as disclosed on the member's Form BD</i>); 2. reflect any relationship between the member and any non-member or individual who is also named; and 3. if it includes other names, reflect which products or services are being offered by the member. 	<p>No applicable standard.</p>	<p><i>Same as standard for retail communication.</i></p>
<p><i>Content Standards:</i> Tax Consideration</p>	<ol style="list-style-type: none"> 1. References to tax-free/exempt income must indicate which income taxes apply, or which do not; 2. Communications must not characterize income or investment return as tax-free or exempt when liability is merely postponed; 3. <i>A comparative illustration of the mathematical principles of tax-deferred versus taxable compounding must meet seven specified criteria.</i> 	<p><i>Standards 2 and 3 under retail communication apply to institutional communication.</i></p>	<p><i>The same standards that apply to retail communication apply to correspondence.</i></p>
<p><i>Content Standards:</i> Disclosure of Fees, Expenses and Standardized Performance</p>	<p>Communications that present certain permitted investment company performance data must disclose performance information mandated by SEC Rule 482 and Investment Company Act Rule 34b-1, among other things. This information must be set forth prominently, and in any print advertisement, in a prominent text box that contains only the required information.</p>	<p>No applicable standard.</p>	<p><i>The same standards that apply to retail communication apply to correspondence.</i></p>
<p><i>Content Standards:</i> Testimonials</p>	<ol style="list-style-type: none"> 1. If a testimonial concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion. 2. Communications providing any testimonial concerning the investment advice or performance of a member or its products must comply with their requirements. 	<p><i>Standard 1 under retail communication applies to institutional communication.</i></p>	<p><i>Standards 1 and 2 under retail communication apply to correspondence.</i></p>
<p><i>Content Standards:</i> Recommendations</p>	<ol style="list-style-type: none"> 1. If a communication includes a recommendation of securities, it must have a reasonable basis and disclose: <ul style="list-style-type: none"> ▪ whether the firm is making a market in the recommended security, or if the member or associated person will sell or buy the security on a principal basis; ▪ if the <i>member or any associated person that is directly and materially involved in the preparation of the content of the communication</i> has a financial interest in the securities of the issuer ▪ if the member was a manager or co-manager of a public offering of any securities of an issuer whose securities were recommended within the past 12 months 2. A member must provide, or offer to furnish upon request, available investment information supporting the recommendation (including, for corporate securities, the price at the time the recommendation is made). 	<p><i>Standard 2 under retail communication applies to institutional communication.</i></p>	<p><i>Standards 2 and 3 under retail communication apply to correspondence.</i></p>

Requirement	Retail Communication	Institutional Communication	Correspondence
	<p>3. Generally, a communication may not refer to past specific recommendations of the member that were or would have been profitable; however, it may set out or offer to furnish a list of all recommendations as to the same type of securities made by the member within the past year if the communication meets certain conditions, including the condition that the communication contain a specified, prominently displayed cautionary legend.</p> <p>4. These requirements do not apply to any communications that meet the definition of “research report” and include required research disclosures.</p> <p>5. The general disclosure requirements for recommendations do not apply to any communication that recommends only registered investment companies or variable insurance products, if such communications have a reasonable basis for the recommendation.</p>		
<p><i>Content Standards:</i> Exceptions for Prospectuses Filed with the SEC</p>	<p>Prospectuses, preliminary prospectuses, fund profiles and similar documents filed with the SEC are not subject to these content standards, except for investment company prospectuses published pursuant to Rule 482 and broadly disseminated free writing prospectuses that are filed with the SEC pursuant to Securities Act Rule 433(d)(1)(ii).</p>	<p>Same exception applies to institutional communication.</p>	<p>Same exception applies to correspondence.</p>

Recordkeeping Requirements

In accordance with Exchange Act Rule 17a-4, records of retail and institutional communications must include:

- a copy of the communication and the dates of first and last use;
- the name of any registered principal who approved the communication and the date of approval;
- if not principal approved, the name of the person who prepared or distributed the communication;
- the source of statistical tables, charts, graphs and other illustrations; and
- if a retail communication is exempt from principal approval, the name of the member who filed the communication with the FINRA Advertising Department, and a copy of the corresponding review letter from FINRA.

Records of correspondence would continue to be governed by NASD Rules 3010(d) and FINRA Rule 4511.

Broadly Disseminated Free Writing Prospectus

One of the more controversial aspects of the proposed rules related to which pre-approval, filing and content requirements should apply to certain free writing prospectuses (“FWPs”) distributed by a broker-

dealer in a manner reasonably designed to lead to broad, unrestricted dissemination.⁶ Under FINRA Rule 2210, such FWP's:

- must be reviewed prior to use by an appropriately qualified registered principal;
- must be filed with FINRA's advertising department, either pre-use or post-use, depending on the subject-matter (if they relate to a registered structured product, they must be filed within 10 business days of first use); and
- must comply with the content requirements under FINRA Rule 2210(d).

Public Appearances

While eliminated as a communication category, public appearances are covered by FINRA Rule 2210(f), which states that they are subject to the general content standards in paragraph (d)(1). In addition, the rule requires disclosures of financial interests and other actual, material conflicts of interest that are present when securities are recommended. All written or electronic materials used in connection with the public appearance would be subject to the rules for the applicable communication category. Member firms are required to have policies and procedures in place for associated persons who make public appearances, which should incorporate training and education of such persons. Firms must maintain documentation of their compliance, and provide such documentation to FINRA upon request.

The conflict disclosure requirements of Rule 2210(f) do not apply to recommendations made during a public appearance by a research analyst pursuant to NASD Rule 2711 concerning research reports or to recommendations of investment company securities or variable insurance products, as long as there is a reasonable basis for the recommendations.

Investment Analysis Tools

With respect to the prohibition in Rule 2210(d)(1)(F) that communications may not predict or project performance, the new rules contain a new, limited exception for performance projections produced by an "investment analysis tool" or performance projections in a written report produced by an investment analysis tool. Such investment analysis tools must meet the requirements of new FINRA Rule 2214, which is a codification of existing interpretive materials with minor changes.

Exemptions

FINRA Rule 2210 allows FINRA to grant an exemption from the principal approval requirements if the exemption is consistent with the goals of protecting investors and the public interest. FINRA will grant such exemptions only where the circumstances are "truly unique" and will maintain records of any exemptions granted. Rule 2210 also gives FINRA the authority to grant an exemption from the pre-use filing requirements for new FINRA members for good cause shown. Finally, FINRA may conditionally or unconditionally grant an exemption from the post-use filing requirements for good cause shown, to the extent such exemption is consistent with the goals of the rule, investor protection, and the public interest.

⁶ For a more detailed discussion, please refer to prior Davis Polk client memoranda: Davis Polk Client Memo, August 22, 2011, [FINRA Files Amended Communications Rules – Impact on Structured Products](#); Davis Polk Client Newsflash, January 17, 2012, [FINRA Communication Rules - Recent Developments Affecting Structured Notes](#).

JOBS Act Impact

The recently enacted Jumpstart Our Business Startups Act (the "**JOBS Act**") will significantly relax restrictions on pre-offering communications by emerging growth companies and their underwriters when contemplating an IPO, as well as eliminate restrictions on the use of general solicitation when any issuer conducts a private offering under Rule 506 of Regulation D or Rule 144A. Broker-dealers that plan to engage in more expanded marketing activities pursuant to the liberalized communication rules under the JOBS Act should consider the applicable requirements under the FINRA communication rules.

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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