



NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

March 24, 2017

Submitted electronically to pubcom@finra.org

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006

RE: Regulatory Notice 17-06: Communications with the Public

Dear Ms. Asquith:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I am pleased to submit the following comments in response to Regulatory Notice 17-06: Communications with the Public (the “Proposal”), in which FINRA seeks comments on proposed amendments to FINRA Rule 2210 (Communications with the Public). The proposed amendments would “create an exception to the rule’s prohibition on projecting performance to permit a firm to distribute a customized hypothetical investment planning illustration that includes the projected performance of an asset allocation or other investment strategy, but not an individual security, subject to specified conditions.” NASAA appreciates the opportunity to offer its comments.

Initially, FINRA notes that the Proposal is “intended to better harmonize regulatory standards” between broker-dealers and investment advisers. The Proposal highlights that “investment advisers often present performance projections in their communication with their clients, particularly concerning financial planning or asset allocation,” and that “the Investment Advisers Act does not prohibit the presentation of projections that comply with the antifraud provisions of the Act.” NASAA shares the desire where appropriate for further regulatory harmonization, but only to the extent that it does not undermine investor protections.² In our

¹ The oldest international organization devoted to investor protection, NASAA was organized in 1919. NASAA’s membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

² See, e.g., Letter from A. Heath Abshire, Arkansas Securities Commissioner and NASAA President, to Elizabeth Murphy, Secretary, SEC, dated July 5, 2013 available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Fiduciary-Duty-Letter-final-07052013.pdf>; Letter from Mike Rothman, Minnesota Commissioner of Commerce and NASAA President, to Brent J. Fields, Secretary, SEC, dated Nov. 28, 2016 available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Comment-on-FINRA-Seniors-Proposal.pdf>.

view, the Proposal's effort to permit broker-dealers to present performance projections and hypothetical investment planning illustrations raises very significant concerns.

Investment advisers generally are compensated on a fee only basis for providing investment advice tailored to individual investors, and investment advisers owe their clients ongoing fiduciary duties to act in their clients' best interests. Broker-dealers, however, receive transaction-based compensation at the point of sale and are held to lower suitability standards when making recommendations. We are mindful, and remain vigilant, to ensure clarity on the boundary between providing investment advice as a business (as an investment adviser does) versus incidental to broker or dealer activities (as broker-dealers do).³ Broker-dealers that advertise hypothetical portfolios, which presumably would require ongoing monitoring to maintain the advertised strategies and investment allocations, but that are not dually registered as investment advisers risk crossing the line into unregistered investment advisory activity or misleading investors as to the nature of their services. Given these inherent regulatory differences, the Proposal's goal to "level the playing field" between broker-dealers and investment advisers when it comes to advertising hypothetical performance is a tall order and appears likely to result in further confusion and blurring or crossing of regulatory lines.

The fiduciary duties investment advisers owe their clients affords investors greater protections than does the suitability standard applicable to broker-dealers. This higher standard of care mitigates the potential risks of investment advisers using projections. An investment adviser must be able to defend any alleged impropriety by showing that the adviser acted in the client's best interest. A broker must only show that its recommendation was suitable, not necessarily the customer's best option.

While NASAA commends FINRA's attempt to make investment information more accessible to retail investors that do not have advisory accounts, the Proposal as currently designed would appear more likely to mislead than to inform investors. As FINRA noted in its release, there are already four exceptions to the prohibition on projections: hypothetical illustrations of mathematical principles, investment analysis tools, price targets in research reports, and certain projections concerning security futures and options. These exceptions are based on quantifiable metrics that would be difficult to distort. The projections contemplated under the Proposal, though, are much more susceptible to manipulation or bias. Furthermore, in

³ Section 202(a)(11) of the Investment Advisers Act of 1940 defines investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." However, "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor" is exempted from the definition of investment adviser. *See* 15 U.S.C. § 80b-2. Therefore, any broker-dealer whose advisory activity is more than incidental to its brokerage services may meet the definition of an investment adviser and become subject to the regulatory requirements applicable to investment advisers.

contrast to the design of the Proposal, a certain degree of backtesting would appear virtually inevitable in the creation of any hypothetical portfolio.⁴

While the Investment Advisers Act does not prohibit an investment adviser from utilizing projections, the SEC has issued an extensive line of no action letters and taken enforcement actions that provide guidance to investment advisers on the uses of hypothetical or model performance.⁵ NASAA members have also cautioned investment advisers about the use of projections through examinations and enforcement actions.⁶ The Proposal as currently framed fails to provide the regulatory rigor necessary for the presentation of hypothetical performance. The Proposal would require FINRA members to make certain disclosures about hypothetical performance and present “all material assumptions and limitations applicable to the illustration,” but this general guidance lacks the regulatory depth that exists for investment advisers.

If FINRA moves forward with a rule permitting a customized hypothetical investment planning illustration that includes the projected performance of an asset allocation or other investment strategy, any such rule should clarify—with specificity—the required disclosures and provide guidance for how members may calculate and present projections. For example, FINRA must consider, among other things:

- How its members are to calculate fees, costs, or commissions in relation to how hypothetical performance is presented;
- How its members must compose an asset allocation or investment strategy for projection;
- How a projection would have a reasonable basis where it was inconsistent with the historical performance of the asset allocation; and
- What is meant by “clearly and prominently” under the Proposal.

Moreover, any rule amendments allowing the types of communications discussed in the Proposal should require disclosure of the underlying securities that make up the customized hypothetical investment planning illustration. FINRA should also consider requiring broker-dealers to inform investors if the broker-dealer’s past projections proved to be inaccurate.

⁴ The Proposal does not sufficiently address backtesting. Our understanding of the Proposal is that FINRA would view any advertised hypothetical portfolio that benefitted in its development from backtesting as *per se* fraudulent. But because a certain degree of backtesting would seem virtually inevitable in the creation of any hypothetical portfolio, as drafted, the Proposal appears unworkable.

⁵ See Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986). See also *In re* Schield Management Company et al., SEC Release No. IA-1872 (May 31, 2000); *In re* The Dreyfus Corporation and Michael L. Schonberg, SEC Release No. IA-1870 (May 10, 2000); *In re* LBS Capital Management, Inc., SEC Release No. IA-1644 (July 18, 1997); Association for Investment Management and Research, SEC No-Action Letter (pub. avail. Dec. 18, 1996); Bramwell Growth Fund, SEC No-Action Letter (pub. avail. Aug. 7, 1996); J.P. Morgan Investment Management, Inc., SEC No-Action Letter (pub. avail. May 7, 1996); Investment Company Institute, SEC No-Action Letter (pub. avail. Aug. 24, 1987); Scientific Market Analysis, SEC No-Action Letter (pub. avail. Mar. 24, 1976).

⁶ See, e.g., *In re Ashland Partners et al.*, Wash. Secs. Div. Order No. S-10-279-14-FO01, 2014 WL 10589090 (July 29, 2014).

Ms. Asquith
March 24, 2017
Page 4 of 4

NASAA fears that without more detailed guidance, the door will be open for broker-dealers to mislead and confuse investors with customized hypothetical investment planning illustrations.

In NASAA's view, the Proposal requires further development to address the important issues raised above, whether through further revisions to the text of the rule or through guidance. NASAA would welcome an opportunity to discuss these issues further. If you have any questions about these comments, please contact NASAA's General Counsel, A. Valerie Mirko, at vm@nasaa.org or (202) 737-0900.

Sincerely,

A handwritten signature in cursive script that reads "Mike Rothman".

Mike Rothman
NASAA President
Minnesota Commissioner of Commerce