

## ADVERTISING THE MUTUAL FUND

### **I. MUTUAL FUND ADVERTISEMENTS**

As the United States mutual fund industry has become increasingly competitive and diverse, flexibility in advertising has become more important. Although the basic statutory premise, to treat a written offer of a security as a prospectus, has remained unchanged, specially designed advertising rules permit mutual funds and their distributors to provide more information to potential investors than operating companies would be permitted to provide in connection with an offer of their securities. This recognizes that securities are in reality the product that a mutual fund has to sell. Advertising and sales literature must, however, be distributed within the framework permitted by the Securities Act of 1933, as amended (the “1933 Act”).

#### **A. Restrictions on Advertising - Section 5 of the 1933 Act**

When a new mutual fund is established and registered with the SEC for public sale, there are three distinct periods in the process, each governed by different advertising rules.

##### **1. Pre-registration period**

No offers, sales, sales literature or promotional activities are permitted during the period immediately preceding the filing of a registration statement with the SEC; cannot precondition the market.

##### **2. Registration period**

From the time a registration statement is filed with the SEC until it is declared effective, only the following written promotional activities are permitted: (i) distribution of “red-herring” prospectuses; and (ii) Rule 482 “omitting prospectus” advertisements.

##### **3. Post-effective period**

After the registration statement is declared effective, the following rules apply:

- a) The full prospectus, often referred to as the “statutory” prospectus, may be distributed freely;
- b) An omitting prospectus which complies with Rule 482 may be used in newspaper, magazine, radio, television and Web site advertising, or mailed to potential investors;
- c) “Generic” advertisements that comply with Rule 135a may be distributed without a prospectus;

- d) Fund profiles which comply with Rule 498 may be used in advertising and mailed to prospective investors (see fund profile discussion); and
- e) All other sales literature must be accompanied or preceded by the statutory prospectus under Rule 34b-1. These materials are referred to as “supplemental sales literature.”
- f) The foregoing controls are all designed to ensure the primacy of the statutory prospectus.

## **B. SEC Advertising Rules**

Section 5 of the 1933 Act prohibits offers of securities unless offered by a Section 10 prospectus. The term “offer” is broadly defined under federal securities laws to include any written communications designed to engender investor interest in a security. Section 2(a)(10) of the 1933 Act defines prospectus to include any “circular, advertisement, letter or communication . . . which offers any security for sale.” Section 5 of the 1933 Act prohibits a person from distributing a prospectus for any security unless it complies with strict disclosure requirements imposed by Section 10 of the 1933 Act. Section 10(a) dictates the content of the statutory prospectus and Section 10(b) permits a “summary prospectus” and an “omitting prospectus.” With a few exceptions, mutual fund marketing materials generally fall within the definition of a prospectus and thereby are subject to these disclosure requirements. However, SEC regulations offer several means of creating marketing materials which can be used to solicit investors without containing the disclosures found in a statutory prospectus, as follows:

1. **Fund Profile/Summary – Form N-1A and Rule 498:** Mutual funds may satisfy their prospectus delivery requirements by providing an investor with a “Summary Prospectus.” The Summary Prospectus must provide investors with a summary of key information about a fund presented in a standardized sequence, thereby allowing easy comparison of funds.
  - a) A Summary Prospectus must include the following information:
    1. The fund's investment objectives and goals;
    2. Fees and expenses, including: (i) a brief narrative alerting investors to the availability of “breakpoint discounts;” (ii) portfolio turnover rate for the most recent fiscal year as a percentage of the average value of the portfolio; (iii) a short explanation of the effect of that portfolio turnover rate on the fund's transaction costs and performance; and (iv) specific captions regarding the effect of expense reimbursements or fee waiver arrangements on disclosed gross operating expenses;

3. Principal investment strategies, risks and performance, including the risk/return bar chart and table illustrating the variability of returns and past performance, as previously required;
  4. The fund's investment adviser(s), portfolio manager(s), and sub-adviser(s) who have significant responsibility for the management of the fund;
  5. The share purchase and sale process, including minimum initial investment requirements and information as to whether shares are redeemable and the procedures for redeeming shares;
  6. Brief tax information; and
  7. Information about payments by the fund or a related entity to financial intermediaries, in order to “alert investors to the potential conflicts of interest.”
- b) A mutual fund may satisfy its prospectus delivery obligations by delivering only the Summary Prospectus to investors as long as specific requirements are met, including:
1. The fund's Summary Prospectus, statutory prospectus, SAI, and most recent annual and semi-annual reports to shareholders are accessible, free of charge, at a website (the website must be disclosed on the cover or at the beginning of the Summary Prospectus);
  2. These disclosure documents are accessible online for at least 90 days after the Summary Prospectus is delivered to investors;
  3. Investors are able to retain an electronic version of the disclosure documents through downloading or otherwise, free of charge;
  4. The full statutory prospectus and the SAI on the website include a table of contents with hyperlinks directing a reader to the relevant sections within the document; and
  5. A reader can hyperlink between the Summary Prospectus and the related sections within the statutory prospectus and the SAI.

## **2. Generic Advertising - Rule 135a**

A notice, circular, advertisement, letter, sign or other communication, published or transmitted to any person, which does not specifically refer by name to the shares of a particular mutual fund, to the mutual fund itself, or to any other

securities not exempt under Section 3(a) of the 1933 Act, is not an offer of any security if the following conditions are fulfilled:

- a) The communication may contain only:
  1. Explanatory information relating to mutual fund shares generally, or to the nature of mutual funds, or to services offered to shareholders of mutual funds;
  2. The mention or explanation of mutual funds of different generic types or having various investment objectives, such as “balanced funds,” “growth funds,” “income funds,” “leveraged funds,” “specialty funds,” “variable annuities,” “bond funds,” and “no-load funds”;
  3. Offers, descriptions and explanations of various products and services which are not securities, if the offers, descriptions and explanations do not relate directly to the desirability of owning or purchasing mutual fund shares; and
  4. An invitation to inquire for further information.
- b) The communication must contain the name and address of the registered broker or dealer or other person sponsoring the communication. If the communication contains a solicitation of inquiries, and if prospectuses for mutual fund shares are to be sent or delivered in response to such inquiries, the communication must state the number of mutual funds involved, and the fact that the sponsor of the communication is the principal underwriter of the mutual funds.
- c) If the communication describes any type of security, service or product, the person sponsoring the communication must offer for sale the security, service or product described in the communication.

### **3. “Omitting Prospectus” - Rule 482**

Rule 482 under the 1933 Act is the primary advertising rule for mutual funds and, in particular, mutual fund performance data may be included in ads in reliance on the rule.<sup>1</sup> A 482 ad is considered a prospectus under Section 10(b) of the 1933 Act and is an “Omitting Prospectus” under that Section. A Rule 482 advertisement need not contain all of, and is not limited to, the information in a

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<sup>1</sup> Compliance with Rule 482 alone is insufficient to avoid liability attached to advertisements. The antifraud provisions found in Rule 156 and Rule 420 still apply.

Section 10(a) prospectus.<sup>2</sup> These ads are the primary vehicle for communicating performance data to prospective mutual fund investors. Rule 482 ads must address a mutual fund that is selling or proposing to sell its securities pursuant to a registration statement which has been filed with the SEC.

- a) General Required Disclosures. A 482 advertisement must include disclosure that:
  1. advises an investor to consider the investment objectives, risks and charges and expenses of the mutual fund carefully before investing;
  2. explains that the prospectus contains this and other information about the mutual fund;
  3. identifies a source from which an investor may obtain a prospectus; and
  4. states that the prospectus should be read carefully before investing.
  
- b) Required Disclosures for Performance Information. A 482 advertisement that includes performance information must disclose:
  1. that performance data quoted is past performance, past performance does not guarantee future results, and current performance may be lower or higher than the performance data quoted;
  2. that an investment's return and principal value will fluctuate such that an investor's shares, when redeemed, may be worth more or less than their original cost;
  3. either a toll-free (or collect) telephone number or a Web site where an investor may obtain performance data current to the most recent month-end unless ads contain performance data current to the most recent month ended seven business days prior to the date of use; and

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<sup>2</sup> In the National Securities Markets Improvement Act of 1996, Congress gave the SEC express authority to create a new "Omitting Prospectus." The objective was to permit the SEC to eliminate the former requirement that the 482 ad only contain information the "substance of which" appeared in the prospectus because this former requirement often led to clutter in fund prospectuses from information included for the sole purpose of later using it in advertisements. The SEC, in September 2003, amended Rule 482 to make this and other changes.

4. if a sales load or any other nonrecurring fee is charged, the maximum amount of the load or fee and, if not reflected, that the performance data does not reflect the deduction of the sales load or fee, and that, if reflected, the load or fee would reduce the performance quoted.
- c) Money Market Fund Disclosures. A Rule 482 advertisement for a money market fund contains additional specific requirements and the ad:
1. must include a legend that any investment in the fund is neither federally insured nor guaranteed, and if the fund holds itself out as maintaining a stable net asset value, it must state that there can be no assurance that the fund will be able to maintain a stable net asset value; and
  2. may omit required performance disclosure (referenced above) about principal value fluctuation.
- d) Standardized Performance Presentations. As noted, unlike advertisements and sales material relying on Rule 135a, Rule 482 material may contain performance data. This data must be calculated in accordance with the specific computation methods prescribed by the SEC. Rule 482 also regulates the manner in which performance data are presented. For mutual funds, performance data must be computed based on methods specified in Form N-1A, must be set out in no greater prominence than other performance quotations, and must identify the length of, and date of the last day of, the base period for the performance in no less prominence than the measurement. The following is an over-view summary of the requirements for Rule 482 materials that contain performance information:
1. Current yield (Non-Money Market Funds): Funds may quote a yield calculated using a specific formula for the most recent 30-day period practicable and must be accompanied by required quotations of total return (item 3 below);
  2. Tax-equivalent yield (Non-Money Market Funds): Funds with significant tax-exempt income may quote taxable-equivalent yield if calculated using a specific formula. This yield must be accompanied by the current yield and the average annual total return that relate to the identical base period.

3. Average annual total return (Non-Money Market Funds): Funds must include the 1-, 5- and 10-year average annual returns as of the most recently completed calendar quarter.
  4. Yield (Money Market Funds): Money market funds may quote a current yield; an effective yield accompanied by a current yield; or a tax-equivalent yield or tax-equivalent effective yield accompanied by a current yield. Any yield must be calculated by a specific formula for the most recent 7-day period practicable and relate to the identical base period as any other yield reported. Money market fund yields need not be accompanied by average annual total returns.
  5. After-tax return: For certain funds, fund advertisements must also show average annual total return (after taxes on distributions) and average annual total return (after taxes on distributions and redemptions) for a recent 1-, 5- and 10-year period, based on the highest federal income tax rate. This standardized after-tax information must be included if the fund represents in some way that it is managed to limit or control the effect of taxes on the fund's performance.
  6. Non-standardized Performance Data. This is permitted, but it must include all elements of return, and be accompanied by standardized total return data which is equally prominent.
- e) Timeliness Requirement. Performance data must be as of the most recent practicable date considering the type of mutual fund and the media through which the data is conveyed.

For total return quotations, this requirement is met if (i) the quotations are as of the most recent calendar quarter-end prior to submission of the ad for publication and (ii) the ad identifies a toll free (or collect) number or an internet address where an investor can find the most recent month-end performance data unless the ad includes total return information current to the most recent month ended seven business days prior to the date of its use.

- f) Prominence Requirement.
1. Print Ads. Rule 482 requires print advertisements to present required narrative disclosures about the prospectus and performance data in a type size at least as large as and of a style different from, but at least as prominent as, that used

in the major portion of the advertisement. One exception is if performance data is presented in a type size smaller than that of the major portion of the advertisement, the required narrative disclosure pertaining to the performance data may appear in a type size no smaller than that of the performance data.

2. Electronic Ads. If an advertisement is delivered through an electronic medium, the type size and style requirements may be satisfied by presenting the required narrative disclosures in any manner reasonably calculated to draw investor attention to them.
  3. Radio and Television Ads. The required narrative disclosures must be given emphasis equal to that used in the major portion of the advertisement.
- g) Proximity Requirement. Narrative disclosures that specifically relate to fund performance are required to be presented in close proximity to the performance data in print, radio and television ads. In addition, for print ads, this disclosure is required to appear in the body of the advertisement and not in a footnote.
- h) Rule 482 advertisements are subject to liability under section 12(a)(2) of the 1933 Act and the antifraud provisions of the federal securities laws. Also, Rule 482 advertisements, as section 10(b) prospectuses under the 1933 Act, are subject to the summary suspension provisions of section 10(b), which permit the SEC to suspend the use of a materially false or misleading prospectus.

#### **4. Supplemental Sales Literature - Rule 34b-1**

- a) In General. Supplemental sales literature is advertising material that must be preceded or accompanied by a statutory prospectus. Since it accompanies or follows a statutory prospectus, supplemental sales literature may include any information that is not misleading, provided it meets the requirements of Rule 34b-1. Rule 34b-1 under the 1940 Act provides that any mutual fund sales literature will be considered materially misleading if it fails to contain the information specified in Rule 34b-1, which essentially incorporates the 482 requirements discussed above.
- b) Additional Disclosures. In addition to the required disclosures under Rule 34b-1, supplemental sales literature should include a legend that makes it clear that a prospectus was previously sent or is enclosed with the ad.



- c) Supplemental sales literature is excepted from the definition of prospectus under Section 2(a)(10)(a) of the 1933 Act.

5. **Newsletters:** Some mutual fund complexes use newsletters to communicate with current shareholders or prospective investors. Newsletters contain a variety of articles, including those that describe new products or services offered by the fund sponsors, or general articles intended to educate or inform readers on broad topics, such as retirement investing. Because most newsletters contain offering material, they must be filed with the Financial Industry Regulatory Authority (“FINRA”) (formerly, the known as the NASD) or the SEC, as applicable.

a) Rule 482 Material in Newsletters

- 1. Rule 482 ads (each, a “482 unit”) appearing in a newsletter must be segregated and presented as a separate unit. This requirement applies to a 482 unit that is part of a larger article.
- 2. If a Rule 482 unit relates to more than one fund, the information relating to each fund must be separate so that it can be identifiable within the article as referring to the specific fund.
- 3. Rule 482 material requires various legends that must be placed in accordance with the rule so that attention is drawn to these legends.

b) Rule 135a Material in Newsletters

- 1. Rule 135a cannot be relied on to permit the generic advertising material (permitted under such rule) to appear in the same newsletter with offering material permitted by Rule 482.
- 2. Rule 135a material may be included in newsletters that include only Rule 135a material and non-offering material.

c) Free Writing (Non-Rule) Material in Newsletters

- 1. Free writing, while it may not be an offer when considered separately from the rest of a newsletter, may be an offer when viewed in the “totality of the circumstances” surrounding the newsletter. Material would probably constitute an offer if it directly or indirectly promotes or encourages a decision by the reader to make a current

investment in a particular fund or funds. It must be tested with respect to:

- (a) the shares of each fund being offered or about to be offered by the mutual fund sponsor distributing the newsletter; and
  - (b) the context of the newsletter and any accompanying materials.
- d) Free writing that is non-offer material may be included in a newsletter, provided that it is segregated from Rule 482 material.
  - e) Free writing that is an offer may be included in a newsletter only if it meets certain other requirements.

### C. **Advertising Standard - Rule 156**

1. **In General.** Rule 156 under the 1933 Act reiterates general anti-fraud standards found elsewhere in the securities laws that relate to advertisements. The emphasis of Rule 156 is on the need for a balanced, truthful discussion of risks and benefits. Moreover, Rule 156 identifies areas which, in the SEC's experience, have provided the greatest opportunity for misleading statements. Rule 156 applies to all types of mutual fund sales material and advertising, not only to sales literature.
2. **Standard.** The main principle of Rule 156 is that in connection with the offer or sale of shares, mutual funds may not use any form of sales literature that is materially misleading. In general, sales literature may be considered misleading if it:
  - a) contains an untrue statement of a material fact;
  - b) omits to state a material fact necessary in order to make a statement made, in light of the circumstances of its use, not misleading; or
  - c) contains statements about possible benefits connected with services to be provided without giving equal prominence to any associated limitations or risks.

## II. **USE OF RELATED PERFORMANCE IN ADVERTISING**

As noted above, Rule 482 and the calculation methodologies incorporated therein govern advertisement of a mutual fund's performance record. The SEC and FINRA (acting as the former NASD) have each addressed in different ways the use of performance from related accounts to promote a mutual fund.

The term “related performance information” generally refers to the performance of other accounts which are managed by an investment adviser in a substantially similar manner to the mutual fund that the same investment adviser advises and to which such performance relates. The types of information that the regulators traditionally restrict include composites of similar accounts and performance information from predecessor accounts.

#### **A. SEC Positions**

Until the later 1990s, the SEC had allowed the use of performance information from related accounts in fund documents only in limited circumstances. In a series of no-action letters, the SEC has permitted greater use of these types of performance information, but has imposed numerous restrictions.

##### **1. Summary of SEC No-Action Letters**

During the 1990s, the SEC staff interpreted the Investment Company Act of 1940, as amended (the “1940 Act”) and the 1933 Act to permit greater use of prior performance of comparable accounts and predecessor accounts in mutual fund prospectuses and, for some categories, the SEC staff has permitted the use of the materials in fund advertising and sales material. Through the SEC staff no-action letter process, the SEC staff has stated that it will not recommend enforcement action for certain types of performance information if selected, calculated and presented in accordance with SEC staff guidelines.

##### **a) Categories**

These categories of permitted related performance information include insurance company separate accounts converted into mutual funds,<sup>3</sup> prior performance information of private and institutional accounts,<sup>4</sup> and performance information from other funds managed by the same investment adviser.<sup>5</sup> The SEC staff has also permitted funds to present in a fund prospectus a portfolio manager’s prior performance as the manager of a substantially similar mutual fund when the manager worked for a different advisory organization.<sup>6</sup>

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<sup>3</sup> MassMutual Institutional Funds (pub. avail. Sept. 28, 1995).

<sup>4</sup> Nicholas-Applegate (pub. avail. Feb. 7, 1997); Nicholas-Applegate (pub. avail. Aug. 6, 1996); GE Funds (pub. avail. Feb. 7, 1997).

<sup>5</sup> ITT Hartford Mutual Funds (pub. avail. Feb. 7, 1997).

<sup>6</sup> Bramwell Growth Fund (pub. avail. Aug. 7, 1996).

b) Conditions

Among the conditions on the use of the related performance information, the no-action letters require that responsible parties for mutual funds undertake to:

1. assure that the accounts chosen have policies, objectives, guidelines and restrictions that were in all material respects equivalent to the fund's;
2. give the related performance information no greater prominence than the fund's own performance information;
3. clearly disclose that the performance shown represents results for different funds or accounts (i.e., that it is not the fund's own performance);
4. clearly disclose that the past performance of the related account is not indicative of past or future performance of the fund;
5. compare the information to a relevant index;
6. calculate performance in accordance with applicable SEC standards; and
7. describe all material differences between the fund and the other account(s).

**B. FINRA Position**

FINRA does not permit the use of related performance information in advertisements and sales material, with very limited exception. The SEC had considered for a number of years NASD rule amendments proposed by FINRA (then the NASD) that would give FINRA members greater freedom to use related performance information, subject to certain restrictions similar to those found in the SEC no-action letters. However, in 2004, FINRA (then known as the NASDR) withdrew these proposed rule changes from SEC consideration.

**1. Summary**

For informational purposes, the proposed rule amendments had proposed to allow certain types of performance information that would have included:

- a) "Clone" performance: the total return of all registered investment companies that have the same investment policies, investment

objectives, investment strategies and investment adviser and subadviser;

- b) “Predecessor” performance: performance of an insurance company separate account, common trust fund or private investment company that has been converted into the mutual fund and that had investment policies, objectives and strategies that were equivalent in all material respects to the mutual fund. The predecessor must also have had the same investment adviser and subadviser (if applicable) as the mutual fund, and substantially all of its assets must have been transferred to the mutual fund in the conversion – the predecessor cannot continue to exist separately after the conversion; and
- c) “Comparison Portfolio” performance: the total return of a composite of other portfolios, including other investment companies, managed by the investment adviser (or, as appropriate, the subadviser) with substantially similar investment policies, objectives and strategies to the mutual fund. The adviser must have independent third-party verification that the creation and maintenance of the composite complies with FINRA standards.

## 2. FINRA Next Steps

The next step by FINRA regarding possible use of related performance in mutual fund advertisements and sales literature remains uncertain.

## C. Practical Advice

Provided that it is not presented in a misleading manner, and subject to certain conditions from the SEC staff’s no-action letters, related performance information may be contained in the statutory prospectus for a mutual fund that is filed with the SEC. As discussed above, however, FINRA prohibits the use of related performance information for mutual funds in its members’ communications with the public. As a practical matter, the final result is that related performance information may only be contained in the statutory prospectus for a new mutual fund distributed by a FINRA member firm.

### 1. Selection of Related Performance Data

- a) Comparable Accounts: To use related performance data, the adviser (or another responsible party) must carefully review the data to assure itself that the performance information relates to comparable accounts. In particular, any related performance information based on a comparison portfolio must be based on portfolios with substantially similar investment policies, objectives, restrictions and strategies. The SEC staff has expressed

concern about investment advisers including dissimilar accounts, whose performance cannot be replicated by the mutual fund.

- b) Composite Data: At the same time, the SEC staff has expressed concern that advisers have incentive to “cherry-pick” their accounts and omit relevant, but uninspiring performance data.
- c) Portfolio Manager Information: Before using prior performance information based on a portfolio manager’s performance at a different investment adviser, the responsible parties need to establish that the portfolio manager was responsible for the performance of the fund during the period to be used. As many investment advisers use “team” approaches, care should be taken to ascertain that the portfolio manager really was the responsible party. In addition, the performance data involves information that the portfolio manager’s new employer did not create or control; thus, advisers can find themselves liable for inaccurate information that they did not create but used in a registration statement.

## 2. Disclosure

As discussed above, the SEC staff’s no-action letters impose conditions on the methodology used to calculate performance data and require that certain disclosure accompany the prior performance information.

- a) Notably, the performance data must be calculated in accordance with SEC rules and be accompanied by total return information and the performance information of the relevant index.
- b) For performance information related to accounts that were not subject to 1940 Act restrictions, the disclosure must so indicate.
- c) The SEC staff has emphasized that funds must provide appropriate disclosure about any differences in fee structures between the related accounts and the mutual fund.
- d) Funds must describe the material differences in the regulation and management of the related accounts.
- e) Finally, funds must disclose the method of calculating the performance.

## 3. Recordkeeping

Funds should obtain from advisers the records to substantiate related performance information included in fund prospectuses. Section 204 under the Advisers Act and Rule 204-2 thereunder require investment advisers to make and to keep

accurate, complete and current books and records including those “necessary to form the basis for or demonstrate the calculation of the performance or rate of return of all managed accounts.” Advisers should assume that the SEC may request information to substantiate related performance data during inspections.

### **III. FINRA REGULATION AND REVIEW**

FINRA is the self-regulatory organization of the securities industry, resulting from the 2007 consolidation of the NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange (“NYSE”). It is the largest self-regulatory organization in the United States; its members include nearly every broker-dealer in the nation that conducts securities business with the public. The SEC oversees FINRA operations, which include developing rules and regulations, reviewing members’ business activities, and designing and operating marketplace services and facilities.

#### **A. FINRA Rules**

The FINRA rulebook currently consists of new consolidated FINRA rules and both NASD Rules and certain NYSE Rules that FINRA has incorporated. FINRA continues to apply NASD Rules for the protection of investors. In interpreting the rule sets, FINRA will continue to apply the same interpretive materials that NASD and NYSE applied prior to closing. For example, FINRA will consider existing NASD interpretive letters and Notices to Members in applying NASD Rules.

#### **B. Rules Relating to FINRA Advertising Review**

1. Section 24(b) under the 1940 Act requires that all mutual fund sales literature be filed with the SEC, or if the material is to be used by a member of FINRA, with FINRA. Because most mutual funds are distributed by FINRA member firms, most mutual sales literature is filed with and reviewed by FINRA rather than with the SEC.
2. FINRA, in a Regulatory Notice published in June 2012, announced that the SEC approved new and reorganized advertising rules that were proposed by FINRA in September of 2009. Specifically, the SEC approved FINRA’s proposed rule change to adopt NASD Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-3 through 2210-8 as FINRA Rules 2210 and 2212 through 2216 (collectively, the “Communications Rules”). The Communications Rules became effective on February 4, 2013.

Under the prior rules, advertisements were broken down into 6 categories (advertisements, sales literature, correspondence, institutional sales material, independently prepared reprints, and public appearances), with varying filing and content standards for member firms depending upon which category a particular advertisement falls. The new

Communications Rules simplify this regime by reducing the possible categories to three: (a) institutional communications, (b) retail communications, and (c) correspondence, and will impose recordkeeping requirements for retail and institutional communications. The new Communications Rules impose different recordkeeping and filing requirements on member firms. Although the new Communications Rules largely incorporate existing content standards, they do incorporate certain FINRA guidance positions into the rules themselves. For example, the prior FINRA position prohibiting a firm from making promissory statements or claims became part of FINRA Rule 2210(d)(1)(B).

3. FINRA reviews members' communications to the public to assure that they are fair, balanced, made in good faith, and compliant with FINRA Rules and federal regulations. Materials must provide a sound basis for evaluating the relevant facts, and no material fact may be omitted.

**C. Advertising Review – General FINRA Rule Standard**

1. The prior NASD Conduct Rule 2210 regulated advertisements and sales literature concerning mutual funds. It provided that member firms' communications with the public should be in accord with principles of "fair dealing and good faith." The rule also included more specific standards governing advertisements and sales literature and other types of communications with the public. FINRA Rule 2210 reorganizes, but largely reincorporates the prior content standards.
2. Communications with the public must not be misleading. Whether or not a communication is deemed misleading depends on the context of the situation, including the financial sophistication of the audience.
3. Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or project the performance of an investment or investment strategy. In addition, FINRA Rule 2210 clarifies that FINRA also allows price targets contained in research reports 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.

**D. Advertising Review - Specific FINRA Rules.** The following is a summary of select FINRA rules that are commonly implicated by firms in developing mutual fund advertising material.



1. **“FINRA Member” Requirement.** All advertisements and sales literature must:

- a) prominently disclose the name of the member, but may also include a fictional name by which the member is commonly recognized;
- b) reflect any relationship between the member and any named non-member or individual
- c) if other names are included, reflect which products or services are being offered by the member.

2. **Mutual Fund Ranking Guidelines**

Prior NASD Rule IM-2210-3 provided guidelines for the use of rankings in mutual fund advertisements and sales literature. FINRA Rule 2212 replaced NASD Rule IM-2210-3, but the applicable standards remain the same.

- a) General Prohibition. FINRA members are prohibited from using mutual fund rankings in any advertisement or sales literature other than rankings created and published by an “Ranking Entity” or rankings created by a mutual fund or an affiliate but based upon performance measurements of a Ranking Entity.
- b) “Ranking Entity” is any entity that provides general information about mutual funds to the public, that is independent of the mutual fund and its affiliates and whose services are not procured by the mutual fund or its affiliate to assign the fund a ranking.
- c) Headlines/Prominent Statements. A headline or prominent statement must not state or imply that a mutual fund is the best performer in a category unless it is actually ranked first in the category.
- d) Required Prominent Disclosures. Members must prominently disclose: the name of the category; the number of funds (or fund families) in that category; the Ranking Entity’s name and, if applicable, the fact that the fund created the category/subcategory; the length of the period and its ending date; and the criteria on which the ranking is based (e.g., total return).
- e) Other Required Disclosure. Members must also disclose: the fact that past performance does not guarantee future results; whether the ranking takes front-end sales loads into account (for those funds that charge such a load); if ranking based on total return or SEC yield and fees/expenses waived had a material effect on such

performance, then a statement to that effect; the publisher of the ranking data; and, if applicable, the meaning of the symbol (e.g., star rankings).

- f) Current Rankings. Generally, rankings must at a minimum be current to the most recent calendar quarter. If no such ranking exists, then a member may only use the most current ranking from the Ranking Entity unless such ranking would be misleading (in which case no ranking may be used).
- g) Time Periods. Except for money market funds, rankings may not cover a period of less than one year, unless based upon yield. If a ranking is based on total return, a ranking must be accompanied by rankings based on total return for the one-, five- and ten-year periods (if in existence for such time periods) provided by the same Ranking Entity for the same category. If no such period rankings exist, a member may use rankings representing short, medium and long term performance for the required periods.
- h) Category. The category choice must be one that provides a sound basis for evaluating the fund's performance. The category must be based on a Ranking Entity's published category (or a category created by a fund but based on performance measurements of a Ranking Entity). Finally, no category may be used if based on asset size of a fund, regardless of whether a Ranking Entity produced it.
- i) Fund rankings for more than one class of a fund (or for feeder funds) must be accompanied by prominent disclosure that the fund classes (or fund feeders) have a common portfolio.
- j) Fund Families. There are special requirements in addition to those above for fund family rankings that should be referenced if a member elects to advertise such rankings.

### **3. Use of Investment Analysis Tools**

The NASD issued IM-2210-6, interpretive material under Rule 2210, which related to the use of investment analysis tools. In so doing, the NASD provided a limited exception to the general prohibition on predictions and projections to allow members to offer such technological tools under certain circumstances. FINRA Rule 2214 replaced NASD Rule IM-2210-6, but the applicable standards remain the same. The highlights of FINRA Rule 2214 are provided below.

- a) Definition of "Investment Analysis Tool." An "Investment Analysis Tool" is "an interactive technological tool that produces simulations and statistical analyses that present the likelihood of

various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices.”

b) Use of Investment Analysis Tools. A member may provide an investment analysis tool, written reports indicating the results generated by such tool, and related advertisements and sales literature only if:

1. the member describes the criteria and methodology used, including the tool’s limitations and key assumptions;
2. the member explains that results may vary with each use and over time;
3. if applicable, the member describes the universe of investments considered in the analysis, explains how the tool determines which securities to select, discloses if the tool favors certain securities and, if so, explains the reason for the selectivity, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and
4. following additional disclosure is displayed:

“IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.”

5. With respect to item (3) above, the disclosure must indicate:
  - (a) among other things, whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered based on revenue received by the member in connection with the sale of those securities or based on relationships or understandings between the member and the entity that created the investment analysis tool; and
  - (b) whether the investment analysis tool is limited to searching, analyzing or in any way favoring

securities in which the member makes a market or has any other direct or indirect interest. Members are not required to provide a “negative” disclosure (i.e., a disclosure indicating that the tool does not favor certain securities).

- c) Clear and Prominent Disclosures. All disclosures described above must be clear and prominent in light of the content, context and presentation of the tool and/or written report. Additionally, if there is a tool and a written report, the disclosures must be clear and prominent on both the tool and the written report.
- d) Post-Use Access and Filing Requirement. A member that offers or intends to offer an investment analysis tool must, within 10 days of first use, (1) provide FINRA access to the investment analysis tool and, (2) file with FINRA any template for written reports produced by, or advertisements and sales literature concerning the tool.

Any member that offers such a tool exclusively to “institutional investors” is not subject to the post-use access and filing requirements discussed above if the communications relating to or produced by the tool meet the criteria for “institutional sales material.” Even if the investment analysis tool were offered exclusively to institutional customers, the member still would have to adhere to the disclosure requirements and would retain suitability obligations to the extent they arise in connection with the use of the investment analysis tool by such institutional customers.

In addition, if a member presents an investment analysis tool on its Web site and non-institutional customers can access and use the tool, the member must comply with the filing requirements and that this would be true even if the member indicated on its Web site that only institutional customers should use the tool.

- e) Other FINRA Rules. FINRA Members that offer an investment analysis tool must ensure that the tool also complies with other regulations such as the FINRA suitability rule (FINRA Rule 2111), provisions of the FINRA Rule 2210 (*e.g.*, principles of fair dealing and good faith and the prohibition on exaggerated, unwarranted or misleading statements).

#### **4. Use of Bond Mutual Fund Volatility Ratings**

- a) Definition. “Bond mutual fund volatility rating” is a description issued by an independent third party relating to the sensitivity of

the net asset value of a portfolio of a mutual fund that invests in debt securities to changes in market conditions and the general economy. This rating is based on an evaluation of objective factors, including the credit quality of the fund's individual portfolio holdings, the market price volatility of the portfolio, the fund's performance, and specific risks, such as interest rate risk, prepayment risk, and currency risk.

b) Prohibition on Use. Bond mutual fund volatility rating may be used only in supplemental sales literature and only when the following requirements are satisfied:

1. The rating does not identify or describe volatility as a "risk" rating.
2. The supplemental sales literature incorporates the most recently available rating and reflects information that is current to the most recently completed calendar quarter ended prior to use.
3. The criteria and methodology used to determine the rating must be clear, concise, understandable, and based exclusively on objective, quantifiable factors. The rating and the Disclosure Statement accompanying the rating must be clear, concise and understandable.
4. The supplemental sales literature conforms to the disclosure requirements described below.
5. The entity that issued the rating provides detailed disclosure on its rating methodology to investors through a toll-free telephone number, a Web site, or both.

c) Disclosure Requirements.

1. Supplemental sales literature containing a bond mutual fund volatility rating shall include a Disclosure Statement containing all the information required by FINRA Rule 2213. The Disclosure Statement may also contain any additional information that is relevant to an investor's understanding of the rating.
2. Supplemental sales literature containing a bond mutual fund volatility rating shall contain all current bond mutual fund volatility ratings that have been issued with respect to the fund. Information concerning multiple ratings may be

combined in the Disclosure Statement, provided that the applicability of the information to each rating is clear.

3. The Disclosure Statement shall also contain all bond mutual fund volatility ratings, including, with respect to each rating:
  - (a) the name of the entity that issued the rating;
  - (b) the most current rating and date of the current rating, with an explanation of the reason for any change in the current rating from the most recent prior rating;
  - (c) a description of the rating in narrative form, containing: a statement that there is no standard method for assigning ratings; a description of the criteria/methodologies used; a statement that not all bond funds have volatility ratings; whether consideration was paid for the rating; a description of the types of risks that rating measures; a statement that the portfolio may have changed since the date of the rating; and that there is no guarantee that the fund will continue to have the same rating or perform in the future as rated.

#### **5. Fund Performance Sales Material**

FINRA Rule 2210 imposes certain disclosure and presentation requirements on certain communications with the public by members that present mutual fund (other than money market funds) performance data. Such communications must disclose: the standardized performance information required by Rule 482 and Rule 34b-1 (each discussed earlier); and, to the extent applicable, the fund's maximum front-end or back-end sales charge and annual operating expense ratio. All of this information be presented prominently and, in any print advertisement, in a prominent text box.

#### **IV. INVESTMENT ADVISERS ACT RESTRICTIONS**

The Investment Advisers Act of 1940 contains certain restrictions on fund advisers seeking to advertise their own performance. The SEC staff has stated that such restrictions do not apply to

mutual fund advertisements, unless such advertisements are directed towards the adviser's existing or potential clients or refer to advisory services that are offered to such persons.<sup>7</sup>

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<sup>7</sup> Munder Capital Management (pub. avail. May 17, 1996).