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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

FINRA's Position On Pre-Inception Index Performance Data

Law360, New York (May 07, 2013, 5:40 PM ET) -- On April 22, 2013, the Financial Industry Regulatory Authority Inc. issued an interpretative letter regarding the use of pre-inception index performance (PIP) data for exchange-traded products (ETPs). The letter formalizes a position with respect to the use of PIP data (sometimes referred to as “hypothetical” or “backtested” index data) in communications with institutional investors.[1]

All communications by FINRA-member broker-dealers are subject to FINRA Rule 2210, which imposes, among other things, content standards, internal approval, review and recordkeeping requirements, and possible filing obligations with FINRA’s Advertising Regulation Department. In recent years, FINRA’s staff has taken the position in advertising review letters and other forums that communications (e.g., fund fact sheets, advertisements and pitchbooks) that show performance based on the application of historical market data to an index for a period of time prior to the inception date of the index are an area of high concern.[2]

FINRA’s staff has issued a number of “do not use” letters to member firms that sought to use PIP data in communications with the public. FINRA’s primary concern with this type of information has been the possibility that PIP data could be manipulated with the benefit of hindsight and could therefore imply unwarranted conclusions about future performance. FINRA’s views on PIP data have varied somewhat over time and across departments and personnel at FINRA. The result largely has been a chilling effect in the market on the use of communications containing PIP data.

In recent years, FINRA’s staff has indicated on several occasions that FINRA was contemplating formalizing a position on PIP data — which it has now done (albeit in a limited way). Although the interpretative guidance permits firms to distribute PIP data only to institutional investors (subject to several requirements), the guidance nonetheless provides some much-needed regulatory clarity for market participants.

Conditions for Using PIP Data

FINRA's guidance permits member firms to distribute PIP data only to "institutional investors," as defined in FINRA Rule 2210(a)(4).[3] A firm distributing PIP data to any institutional investor that is a financial intermediary must instruct the intermediary not to circulate communications containing PIP data to non-institutional clients. In addition, the member firm must not have any reason to believe the intermediary has or would distribute institutional communications in a manner inconsistent with FINRA's requirements. If the member firm becomes aware that the financial intermediary has circulated communications containing PIP data to non-institutional investors, the firm must cease distributing such materials to that financial intermediary. It is unclear from FINRA's guidance if and when distribution of such materials to the intermediary may resume.

FINRA's interpretive guidance limits the usage of PIP data to indexes that have been developed according to predefined rules that cannot be altered except under "extraordinary market, political or macroeconomic conditions."[4] Further, PIP data may be used only in connection with exchange-traded notes (ETNs) and exchange-traded grantor trusts or exchange-traded registered investment companies (ETFs) (which FINRA collectively refers to as "ETPs") that are passively managed. PIP data cannot be used to market actively managed ETPs.

PIP data must be provided as of the most recently ended calendar quarter and must be provided for a period of time long enough to include "multiple securities market environments." This period of time must be no shorter than 10 years prior to the inception of the index.[5] PIP data must be clearly labeled and must be presented separately from actual performance. In addition, if the ETP has existed for more than one year, the use of PIP data must be accompanied by a prominent presentation of actual ETP performance, which must be net of fees and expenses. The precise dates for both PIP data and any actual data must also be included.

A firm will be permitted to use PIP data that is not contained in the ETP's prospectus, but the PIP data cannot be inconsistent with the content of the ETP's prospectus. As a result, member firms that create or distribute ETP communications containing PIP data should have policies and procedures for reviewing ETPs' current prospectuses, maintaining a database of prospectus changes for each ETP, and ensuring that any ETP communications that contain PIP data and are still in use by the firm are consistent with any prospectus changes.

The guidance indicates that PIP data must also reflect the deduction of fees and charges that are applicable to the ETP. This will heighten the complexity of calculating PIP data and may require firms to make certain assumptions in their calculations, which will also have to be disclosed. This requirement marks a departure from the standard practice of disclosing that actual index performance "reflects no deduction for fees, expenses or taxes" charged to a fund.

Hard copy marketing materials must offer to provide the recipient with the rule set or methodology of the ETP index upon request, and electronic marketing materials must include a hyperlink to such information. As a result, firms that use hard copy materials will have to notify their customer servicing and administrative personnel to timely respond to such requests, and firms that use electronic materials will have to incorporate these new portions of their website or third-party websites into their compliance policies and procedures to ensure that content is accessible and up to date.

FINRA also specified that the following disclosures must be included in communications containing PIP data:

- "For use with institutions only, not for use with retail investors."
- The ETP is a new product, and any performance prior to the date of index inception is hypothetical.
- If the PIP data is produced by an index provider that is paid for by the fund sponsor to produce the data, disclosure of the arrangement and the identity of the index provider.
- The PIP data results are based on criteria applied retroactively with the benefit of hindsight and knowledge of factors that may have positively affected its performance, and the PIP data cannot account for all financial risk that may affect the actual performance of the ETP.
- The actual performance of the ETP may vary significantly from the PIP data.
- Any known reasons why the PIP data would have differed from actual performance during the period shown. For instance, this may include assumptions regarding transaction costs, liquidity, or other market factors.

Other Considerations for Users of PIP Data

FINRA's guidance also notes that, with respect to a member firm's suitability requirements for recommendations to institutional customers, the firm "must be careful to not give excess weight to PIP data" and should "consider the correlation between PIP data and actual performance" for similar ETPs managed by the sponsor or investment adviser. These statements imply that communications containing PIP data may not be able to stand solely on the information contained within the four corners of the communication if they rise to the level of an investment recommendation. At that point, member firms may be required to undertake critical analyses of the PIP data and other relevant information in order to meet their suitability obligations.

FINRA also indicated that firms should consider the following when deciding whether to use PIP data in communications sent to institutional investors:

- The assumptions, rules, and criteria used to create the PIP data, in sufficient detail as to permit the firm to clearly understand how the PIP data could be replicated, using readily available market data.
- The reputation of the entity that created the PIP data, and if the sponsor of the ETP paid for creation of the model, how any material conflicts of interest have been addressed or mitigated.
- The conditions under which the PIP data may not be effective in predicting how the ETP may perform (e.g., very low-interest or high-interest rate environments).
- The source of the data used to produce the PIP data.
- The extent to which the PIP data has been tested under varying market conditions and scenarios, based on both an analysis of historical data and simulations or stress tests.

- Any reasons why the PIP data would have differed from the actual performance of the ETP during the period shown (e.g., transaction costs and market liquidity).

Implications

FINRA's interpretative guidance potentially impacts the ETP industry in a number of ways:

- It will once again permit ETPs to use PIP data in connection with communications to institutional investors.
- Some institutional investors have expressed a preference to be able to use PIP data to compare indexes and ETPs prior to making investment decisions.
- The ability to present PIP data to institutional investors may increase the likelihood of ETPs being launched on newer and alternative indexes since ETP sponsors will be able to use marketing materials that include the pre-inception performance of an ETP's underlying index. The availability of additional information may help such newer indexes and ETPs compete with older and more established indexes and ETPs.
- The ability to use PIP data could help facilitate a recent trend in the industry toward self-indexing by asset managers and ETF sponsors. Over the last few years several asset managers and ETF sponsors have filed for SEC orders to permit "self-indexed" ETFs. The use of the self-index business model is viewed by some as a way to differentiate product and reduce index licensing fees. This guidance potentially supports this trend by allowing sponsors of self-indexed ETPs to provide additional information about their unique index methodologies to institutional investors.

—By Richard F. Morris and John J. O'Brien, Morgan Lewis & Bockius LLP

Richard Morris is a partner in Morgan Lewis & Bockius's investment management and securities industry practice, resident in the New York office. John "Jack" O'Brien is an associate in the investment management practice, resident in the Philadelphia office.

[1] FINRA, Interpretative Guidance Regarding the Use of Pre-Inception Index Performance in Institutional Communications (Apr. 22, 2013), available at http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P246651.

[2] The inception date of an index is the date the index was first calculated in real time, using current (as opposed to historical) market data.

[3] “Institutional investors” include any of the following: (A) a person described in FINRA Rule 4512(c)—regardless of whether that person has an account with a FINRA member, which generally includes any bank, savings and loan association, insurance company, registered investment company, or Securities and Exchange Commission– or state-registered investment adviser—or any other person with total assets of at least $50 million; (B) a governmental entity or subdivision thereof; (C) an employee benefit plan, or multiple employee benefit plans offered to employees of the same employer, that meets the requirements of section 403(b) or section 457 of the Internal Revenue Code and has at least 100 participants but does not include any participant of such a plan; (D) a “qualified plan,” as defined in section 3(a)(12)(C) of the Securities Exchange Act of 1934, or multiple qualified plans offered to employees of the same employer, that has at least 100 participants but does not include any participant of such a plan; (E) a FINRA member or registered associated person of such a member; and (F) a person acting solely on behalf of any such institutional investor.

[4] This requirement may need further clarification from FINRA as the methodology underlying most indexes is subject to change from time to time at the direction of an index committee or index administrator and subject to appropriate public notice periods. FINRA’s intent behind this condition is likely an attempt to prohibit PIP data presentations where the underlying index can be changed at the discretion of the ETP or the ETP’s sponsor/adviser, which would represent a conflict of interest and could result in the type of cherry-picked performance presentations that FINRA’s general prohibition on PIP data was intended to eliminate.

[5] This requirement may also need further clarification from FINRA as to the meaning of “securities market environments.” It also appears from the language of the guidance that 10 years is a minimum length of time but may be insufficient if there have not been “multiple securities market environments” during the prior 10-year period. FINRA’s intent behind this condition is likely, again, an attempt to prohibit cherry-picked performance presentations that would cease prior to unflattering market performance of the index or ETP. This requirement may limit the ability of ETPs based on emerging or frontier markets to use PIP data, as underlying price data in these markets may not be available for the required 10-year period.