Investment Company Topics
Thursday, October 24, 2019
11:30 a.m. – 12:30 p.m.

Join FINRA staff and industry panelists as they discuss advertising compliance issues concerning registered investment companies, including mutual funds, ETFs and closed-end funds. The panel includes discussions on current topics and trends, including innovative products, regulatory interpretations and compliance tips.

Moderator: Gregory Riviello
Director, Advertising Regulation
FINRA Advertising Regulation

Speakers: Meredith Henning
Managing Director, Advertising Compliance
Foreside

JoDee Murphy
Assistant Vice President, Compliance Manager
ALPS Fund Services, Inc.

Richard Vagnoni
Senior Economist, Office of Financial Innovation
FINRA Office of Financial Innovation (OFI)

Investment Company Topics Panelist Bios:

Moderator:

Gregory Riviello is a director in FINRA's Advertising Regulation Department which is responsible for the regulation of FINRA member firms' communications with the public. Mr. Riviello is responsible for supervising the daily activities of staff devoted to the review of communications filed with the Department. He provides guidance to Department staff and FINRA firms on the application of the advertising rules and interpretations and also assists with the development of these rules. His other responsibilities include coordinating the Department's training and quality control functions. Mr. Riviello has spoken about various advertising regulation topics at industry events and at the FINRA Advertising Regulation Conferences. Mr. Riviello has 39 years of experience in the securities industry including 29 years with the Advertising Regulation Department. He is a graduate of West Chester State University in West Chester, Pennsylvania, and holds an MBA from the University of Maryland.

Speakers:

Meredith Henning, Managing Director of Advertising Compliance, joined Foreside in 2005. She oversees the advertising compliance function for open- and closed-end funds, exchange-traded products, commodity pools and private placements. Prior to joining Foreside, she was a manager of client services for a Chicago based mutual fund company and also served as a manager of investor services for an online brokerage firm. She holds FINRA series 7, 24, 63 and 79 registrations.

JoDee B. Murphy, Assistant Vice President and Compliance Manager, has more than 18 years of financial services industry experience, including 16 years focused on the review of marketing collateral. Ms. Murphy graduated from the University of Colorado with a B.A. in Psychology. She has obtained the S6, S26 and S99 registrations and in her current role at ALPS she oversees the advertising department and is responsible for the review and approval of all mutual funds and exchange traded funds' marketing collateral.

Richard Vagnoni is Senior Economist in FINRA's Office of Emerging Regulatory Issues in Washington, DC. Mr. Vagnoni provides economic analysis support, studies relevant academic and industry research, and monitors and analyzes new and innovative products, including exchange-traded products and structured retail products. Mr. Vagnoni has a B.A. from the Johns Hopkins University and a Ph.D. from the University of California, Santa Barbara, both in economics.

Investment Company Topics
Thursday, October 24, 2019
11:30 a.m. – 12:30 p.m.

Join FINRA staff and industry panelists as they discuss advertising compliance issues concerning registered investment companies, including mutual funds, ETFs and closed-end funds. The panel includes discussions on current topics and trends, including innovative products, regulatory interpretations and compliance tips.

Moderator: Gregory Riviello
Director, Advertising Regulation
FINRA Advertising Regulation

Speakers: Meredith Henning
Managing Director, Advertising Compliance
Foreside

JoDee Murphy
Assistant Vice President, Compliance Manager
ALPS Fund Services, Inc.

Richard Vagnoni
Senior Economist, Office of Financial Innovation
FINRA Office of Financial Innovation (OFI)

I. Introduction

II. ESG Funds
   a) What are they?
   b) Regulatory issues

III. Interval Funds
   a) What are they?
   b) Regulatory issues

IV. Defined Outcome Registered Investment Company Products
   a) What are they?
   b) Regulatory issues

V. Pre-Inception Performance
   a) FINRA pre-inception index performance interpretive guidance
   b) Use with institutional clients

VI. Industry and FINRA Collaboration

VII. Wrap-up

Investment Company Topics

Panelists

- **Moderator**
  - Gregory Riviello, Director, Advertising Regulation, FINRA Advertising Regulation
- **Panelists**
  - Meredith Henning, Managing Director, Advertising Compliance, Foreside
  - JoDee Murphy, Assistant Vice President, Compliance Manager, ALPS Fund Services, Inc.
  - Richard Vagnoni, Senior Economist, Office of Financial Innovation, FINRA Office of Financial Innovation (OFI)

To Access Polling

- Under the “Schedule” icon on the home screen,
- Select the day,
- Choose the Investment Company Topics session,
- Click on the polling icon: 

ESG Investing

- Environmental, Social, and Governance (ESG) investing
  - Also referred to as Socially-Responsible Investing (SRI)
  - Environmental: climate change, clean technology, pollution abatement, and water conservation
  - Social: gender and diversity policies, workplace safety, human rights, labor standards, and employee relations
  - Governance: executive compensation, board diversity, political contributions, anti-bribery and corruption policies
  - Objective is to generate competitive financial returns while creating a positive impact on society

Polling Question 1 – ESG Investing

1. **Does your firm currently distribute or plan to distribute within the next 12 months, ESG registered investment company securities i.e., mutual funds, ETFs UITs closed-end funds?**
   a. Yes
   b. No

ESG Investing

- Significant market growth (2018 estimate of $12 trillion)
- Mutual funds, ETPs, “green” bonds, and others
- Institutional investors, but increasingly retail
- Performance?
- Risks and concerns
  - Lack of consistency in ESG criteria
  - Lack of transparency in ESG methodologies
  - Potentially misleading marketing and communications
  - Potentially limited diversification

ESG Investing

- Many investors find environmental, social and governance factors important when choosing an investment.
- Many fund companies have different approaches to the screening for these types of investments.
- Not one size fits all. It is important for the investor to understand “doing well by doing good” still involves risk.
- While ESG investing may have many benefits, it does not mean the investments will perform better.

ESG Investing

- Materials should always disclose the primary risks as identified in the prospectus.
- Depending on the focus of the material, risk information may need to be embedded within the main body of the text to balance the language.
- Compliance staff should review specifically on the ESG strategy being promoted. There is not a one size fits all disclosure as there are many worthwhile causes to support and they all do not have the same level of risk.

ESG Investing

- ESG metrics are not reported equally, therefore it is on the investor or the adviser to understand the issues of each individual product. This translates the same for the compliance staff.
- The compliance staff needs to be trained properly to review the product.

Interval Funds

- Interval funds are a type of closed-end fund.
- They are often marketed as high-yielding investments with returns that are less volatile than the broader stock market.
- Interval funds also offer retail investors access to alternative investment strategies and illiquid assets such as catastrophe bonds, private company stock, real estate and peer-to-peer loans, among others.
- Interval funds offer to repurchase their shares from shareholders at periodic and predetermined intervals, generally three, six or 12 months.

Interval Funds

Limited Redemption Opportunities

- Interval funds typically price daily at net asset value (NAV), however, redemptions are limited.
- Rather than trade in the secondary market, they periodically offer to repurchase a percentage of outstanding shares from investors on a pro-rata basis.
- There is no guarantee a shareholder can redeem the desired number of shares during the redemption period, making them generally illiquid.

Interval Funds

- **NSCC/AIP**
  - Interval funds can either be offered through the National Securities Clearing Corporation (“NSCC”) or Alternative Investment Product (“AIP”) Services.
  - NSCC is typically used by traditional mutual funds to provide clearing, settlement, risk management, and information services to the financial industry.
  - AIP standardizes the way global market participants communicate information concerning alternative investments, removing the manual operational challenges that can be associated with these types of products.

Interval Funds

- **Onboarding Requirements**
  - Intermediary platforms that offer interval funds alongside traditional open-end mutual funds tend to have stricter onboarding requirements for alternative funds.
  - They may require significant investor demand, a more extensive due diligence review, and potentially charge higher fees due to the operational restrictions associated with supporting these products.
  - It is essential to keep in mind that not all intermediaries support this structure for onboarding and use by their advisor base.

Interval Funds

Attraction of Interval Funds

- Since interval fund portfolio managers are not concerned with meeting daily redemption requests, they are able to invest in assets or implement investment strategies that may be less liquid and more suited to longer holding periods.
- They also have the ability to invest in alternative types of assets, all of which lend to the possibility for higher returns than open-end mutual funds.

Interval Funds

- **Education is Key**
  - Factsheets on strategies are a baseline, but with a non-standard vehicle, developing content to educate advisors on the structure and operational complexity is critical.
  - Intermediaries and advisors may require additional insight into the mechanics of the need for this vehicle, how it works, differences, benefits, and risks.
  - Also, continued advocacy with industry groups such as the Broker-Dealer Advisory Committee (“BDAC”) at ICI to innovate around improving and automating operational complexities is necessary.

Interval Funds

Disclosure Tips

- Must be labeled appropriately as an interval closed end fund. This language should be prominent and clearly labeled.
- If your Form N2 or prospectus states the interval closed end fund is non-diversified this must also be clearly labeled.
- Specific key risks must be adequately explained.
- Key risks must be shown prominently and not placed in a footnote.
- If the concept of liquidity is mentioned in an advertisement the limited liquidity disclosure should be more prominent than other fund risk disclosures.

Interval Funds

- **Key risks might include the following:**
  - **The Fund should be considered a speculative, long-term investment of limited liquidity that entails substantial risks, and prospective investors should invest in the Fund only if they can sustain a complete loss of their investments.**
  - **Investing in the Fund involves risks, including the risk that a shareholder may receive little or no return on their investment or that a shareholder may lose part or all of its investment.**

Interval Funds

- **Key risks might include the following:**
  - **Shares of the fund will not be listed on any securities exchange, which makes them inherently illiquid. An investment in the fund's shares is not suitable for investors who cannot tolerate risk of loss or who require liquidity, other than liquidity provided through the fund's repurchase policy. The Fund is suitable only for investors who can bear the risks associated with the Fund's limited liquidity and should be viewed as a long-term investment.**
  - **The Fund may pay distributions in significant part from sources that may not be available in the future and that are unrelated to the Fund's performance, such as a return of capital, borrowings or expense reimbursements and waivers. (Once the fund has paid distributions from non-income sources this needs to be disclosed.)**

Interval Funds

- **Key risks might include the following:**
  - **Liquidity for the Shares will be provided only through quarterly repurchase offers between 5% and 25% of the Shares at NAV, and there is no guarantee that an investor will be able to sell all the Shares that the investor desires to sell in the repurchase offer. Due to these restrictions, an investor should consider an investment in the Fund to be of limited liquidity.**

Interval Funds

- Disclosure Tips When Marketing Interval Funds (refer to document in resource section)
  - SEC Rule 482
  - Fees and costs
  - References to liquidity
  - Distributions and return of capital

Defined Outcome Investments

- **Defined outcome investing: New terminology for payoffs historically found in structured retail products**
  - **Example: Limit potential losses in exchange for limiting gains**
  - **Often reflect embedded optionality**
  - **Generally considered to be “complex”**
- **Various efforts to expand availability of these payoffs**
  - **Annuities, closed-end funds, mutual funds, UITs, and ETFs**
  - **Targeting wider retail investor audience**
  - **Addressing common historical criticisms of structured notes**
    - Opacity, relatively high costs, illiquidity, and counterparty credit risk

Defined Outcome Investments

- **ETF example**
  - **Provide a "defined outcome" at the end of a one-year period**
    - Exposure to gains in the S&P 500, up to a cap (e.g., 10%)
    - Protection against index losses (e.g., the first 15% of losses)
    - If investor buys at launch and holds to the end of the one-year period
      - Index loses 20%: investor loses 5%
      - Index loses up to 15%: investor return is 0%
      - Index gains 5%: investor return is 5%
      - Index gains 10% or more: investor return is 10%
  - **Exposure is re-set at the end of the one-year period**

Defined Outcome Investments

- Concerns
  - As the target audience for such products expands, the potential novelty and inherent complexity of the payoff structures as well as the variety of products in which they now appear may heighten the risk of mis-selling.
  - Financial advisors and investors may not fully appreciate the trade-offs between the various risks and benefits offered by these products, such as the potential cost of downside protection.
  - They also may not fully understand how structured payoffs should be used in a portfolio, how optionality embedded in the products can impact their ongoing valuation and performance, or how the different product structures may affect investing experience and outcomes.

Defined Outcome Investments

- Reviewing sales material for these investments can be different due to the complexity of the product which is why education for the reviewers has become critically important.
  - Open lines of communication are key.
  - Working with the portfolio managers and/or investment strategists is helpful as they can communicate the concepts best.
  - Compliance teams or individuals approving sales materials need to learn the strategy mechanics and be able to provide concise comments to help in the production of compliant marketing material.

Defined Outcome Investments

- The material should not imply any level of protection, this triggers concerns from regulators.
- Clarifying language should be in the body of the material and not relegated to disclosures at the end of the material.
- Disclosures must be clear and easy to understand for the retail investor.
- Build in review time to provide appropriate feedback for the material. Set appropriate expectations and ask questions.

Pre-Inception Index Performance

- Interpretive letter to Meredith F. Henning, Foreside
  - January 31, 2019
  - A member firm may include pre-inception index performance data in institutional communications concerning registered open-end investment companies.
- Interpretive letter to Bradley J. Swenson, ALPS Distributors, Inc.
  - April 22, 2013
  - A member firm may include pre-inception index performance data in institutional communications concerning exchange traded products.

Pre-Inception Index Performance

- Must only be used with institutional clients.
- Firms find it useful in helping institutional clients make better investment decisions.

Pre-Inception Index Performance

- **Key Guidance Tips:**
  - Pay close attention to #2 of the PIP guidance (Any PIP data would be used only with respect to an Index created according to a pre-defined set of rules that cannot be altered except under extraordinary market, political or macroeconomic conditions)
  - If the methodology is changed and it is not due to extraordinary market, political or macroeconomic conditions you will not be able to use PIP going forward.

Pre-Inception Index Performance

- **Key Guidance Tips:**
  - When showing PIP data, it must be presented separately from actual performance.
  - The presentation of PIP data will reflect the deduction of fees and charges applicable to the ETF (no exception)

Resources

- **FINRA Interpretive Letters**
  - **Interpretive Letter to Meredith F. Henning, Foreside**
  - **Interpretive Letter to Bradley J. Swenson, ALPS Distributors, Inc.**
- **FINRA Investor Insights**
  - ***Investor Tips: Interval Funds – 6 Things to Know Before You Invest***

Interval Funds

THINGS TO NOTE:

- SEC Rule 482 (b)(3) – applies to *open-end investment companies* which is the performance disclosure legend; however, an interval fund that is showing performance must be fair and balanced. At a minimum, the general past performance disclosure must be included (performance quoted represents past performance and does not guarantee future results).
- SEC Rule 482(d)(3) – average annual total returns (standardized performance) be based on computation prescribed in Form N-1A; however, if an interval closed-end fund does not show standardized performance then the periods shown for performance should be shown for short, medium and long periods so that the item is fair and balanced and not misleading by only showing one period of time.
- Must label fees appropriately. For example, Gross, Total, Total excluding certain fees, etc., must be named according to the prospectus fee table.
- If the interval fund offers different share classes which are subject to distribution fees and additional costs such as front-end, trailing and redemption fees, this material information must be disclosed.
- Be careful when referring to interval funds as being liquid. Because a repurchase is done on a pro rata basis there is no guarantee you can redeem all of your shares during a redemption window. This is at the Fund's discretion but typically it is a 5% minimum-25% maximum per quarter. This information is found in the prospectus and should be worded accordingly.
- When discussing Distributions and Return of Capital, it can not be referred to as a Dividend or Yield.
- You have to affirmatively state that Return of Capital was paid. No "may" language can be included.

SS&C | ALPS