

# Client Alert

Chapman and Cutler LLP  
Attorneys at Law • Focused on Finance®

CURRENT ISSUES RELEVANT TO OUR CLIENTS

JUNE 6, 2012

## FINRA Issues Additional Guidance on New Suitability Rule

New Financial Industry Regulatory Authority, Inc. ("FINRA") rules governing broker-dealer "know your customer" and suitability obligations (FINRA Rules 2090 and 2111) become effective July 9, 2012. In response to several requests, FINRA recently issued Regulatory Notice 12-25 providing additional guidance on implementing the suitability rule. This Client Alert highlights several of the key issues addressed in the guidance. The FINRA notice is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf>. For further discussion on the new rules proposal, please refer to the following publications:

- Doing Business Under FINRA's New Suitability and KYC Rules (April 10, 2012) available at <http://www.chapman.com/media/news/media.1172.pdf>
- FINRA Announces New Know-Your-Customer and Suitability Compliance Date and Interpretive Guidance (May 19, 2011) available at <http://www.chapman.com/media/news/media.1012.pdf>
- SEC Approves FINRA Know-Your-Customer and Suitability Rules (January 18, 2011) available at <http://www.chapman.com/media/news/media.916.pdf>

### Suitability Rule

The new FINRA Rule 2111 "suitability" obligation is modeled on current NASD Rule 2310. The new rule requires a FINRA member firm or associated person to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with a recommended transaction or investment strategy. There is no specific list of required data, but a member must obtain and analyze enough customer information to have a reasonable basis to believe the recommendation is suitable.

The supplementary material of the new suitability rule also codifies interpretations of the three main suitability obligations:

- *Reasonable Basis Suitability*: a FINRA member or associated person must have a reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for at least *some investors*. In general, what constitutes adequate due diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy.
- *Customer-Specific Suitability*: a FINRA member or associated person must have reasonable grounds to believe that the recommendation to a customer is suitable for that particular customer based on that customer's investment profile, as delineated in Rule 2111(a).

Attorney Advertising Material

- *Quantitative Suitability*: a FINRA member or associated person who has actual or de facto control over a customer account must have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

The new suitability rule also introduces the "investment strategy" concept to the suitability rule so that the rule explicitly covers a recommended "investment strategy" in addition to a recommended "transaction". The rule emphasizes that the term "investment strategy involving a security or securities" is to be interpreted broadly. The rule is triggered when a firm or associated person recommends a security or strategy regardless of whether the recommendation results in a transaction. Among other things, the term "strategy" would capture a broker's explicit recommendation to *hold* a security or securities (i.e., where no transaction occurs). The rule recognizes that customers may rely on firms' and associated persons' investment expertise and knowledge, and it is thus appropriate to hold firms and associated persons responsible for the recommendations that they make to customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation. FINRA, however, exempted from the new rule's coverage certain categories of educational material as long as such material does not include (standing alone or in combination with other communications) a recommendation of a particular security or securities. The following communications are excluded from the coverage of Rule 2111 as long as they do not include a recommendation of a particular security or securities:

- General financial and investment information, including (a) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment; (b) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices; (c) effects of inflation; (d) estimating future retirement income needs; and (e) assessment of a customer's investment profile;
- Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the

benefits of plan participation, and the investment options available under the plan;

- Asset allocation models that are (a) based on generally accepted investment theory, (b) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (c) in compliance with NASD IM-2210-6 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD IM-2210-6; and
- Interactive investment materials that incorporate the above.

### Additional Guidance: Q&A

---

In its earlier Regulatory Notices, FINRA addressed numerous issues that members raised as they began assessing the new rule. Firms, however, have again asked FINRA for additional guidance on certain issues. FINRA notes that although many of the obligations under the new rule are the same as those under the existing rule, guidance, and interpretations, it is now providing answers to specific questions regarding FINRA Rule 2111. Several of the questions and answers are summarized below. Please refer to Regulatory Notice 12-25 for a complete discussion.

### Best Interests

- *What does it mean to act in a customer's "best interests?"* FINRA notes that a broker's recommendations must be consistent with its customers' best interests and provides examples of violations of such obligation. The cost associated with a recommendation is one of several factors when determining suitability, along with the customer's investment profile, the product's investment objectives, liquidity, risk, and others. As a result, FINRA notes that the suitability rule and best interest concept are "inextricably intertwined." Although FINRA has not mandated a fiduciary duty to customers, it has previously stated that the application of the suitability standard is not inconsistent with a fiduciary standard.

## Recommendations

- *What factors determine whether a recommendation has been made?* FINRA does not define “recommendation” but has offered several guiding principles in past Regulatory Notices, cases, and interpretive letters which remain generally applicable. For example, the use or distribution of marketing or offering materials ordinarily would not constitute a recommendation. Also, the suitability rule would apply to recommendations of private placements.
- *When does an implicit recommendation trigger the suitability rule?* FINRA and the SEC have recognized that certain actions constitute implicit recommendations that can trigger suitability obligations. The new rule does not broaden the scope of such implicit recommendations. For example, the new rule does not apply an implicit recommendation to the holding of a security. A hold recommendation must be explicit to trigger the obligation.

## Customers

- *What constitutes a “customer” for purposes of the suitability rule?* FINRA defines “customer” broadly as anyone who is not a broker or dealer, with certain additional parameters. A person with whom a broker-dealer has even an informal business relationship related to brokerage services would qualify as a customer (unless he or she is not a broker or dealer). The rule would apply, for example, when a broker recommends a security to a potential investor, even if such person has no account with the firm.

## Investment Strategy

- *What is an “investment strategy?”* Rule 2111 states that the term is to be interpreted broadly, and would cover, for example, a recommended investment strategy involving securities regardless of whether the recommendation results in a transaction or even mentions a specific security or securities. The rule would also apply to recommendations to invest in specific types of securities, such as “Dogs of the Dow,” or in a particular market sector. The rule would also apply to recommendations generally to use a bond ladder, day trading or margin strategy involving securities (regardless of whether any particular security is mentioned). FINRA notes the importance of focusing on whether the recommendation was suitable when made—a recommendation to hold or maintain an investment strategy would not normally

create an ongoing duty to monitor and make subsequent recommendations.

- *What is the scope of the safe-harbor provision regarding the use of an asset allocation model?* Rule 2111 excludes various types of educational communications as long as they do not include a recommendation of a particular security or securities and comply with the provisions of the rule. This safe harbor would apply, for example, if a recommendation is based on an asset allocation model that meets all of the rule’s criteria and the firm does not recommend any particular security or securities. FINRA notes, however, that as an allocation becomes narrower or more specific, the recommendation becomes closer to being that of a particular security or securities. Firms should assess whether allocation recommendations of sub-sectors of broader market sectors or even more limited groupings are too specific.
- *Does the “investment strategy” provision cover recommendations of both a security and a non-security investment?* The new suitability rule would cover such recommendations beyond securities. A firm’s supervisory system must be reasonably designed to achieve compliance with this rule, as well as all applicable securities laws and regulations and FINRA rules. Such system may be risk-based, using, for example, reasonably detection, investigation and follow-up of “red-flags” indicating that a broker may have recommended an unsuitable strategy utilizing both a security and a non-security component.

## Risk-Based Compliance

- *What types of recommendations does FINRA generally consider complex or potentially risky?* FINRA has stated that although a member has a general obligation to evidence compliance with FINRA rules, the suitability rule does not include explicit documentation requirements, except where a firm declines seeking certain customer information in the first place. All recommendations of a security or investment strategy involving a security is covered by the suitability rule, but the extent to which documentation of suitability analyses is needed depends on an assessment of the customer’s investment profile and the complexity of the recommended security/strategy and its risks. The recommendation of a large-cap, value-oriented equity security would usually not require documentation, as opposed to complex products, such as structured

products, which are discussed in numerous Regulatory Notices and would require documentation.

### Information-Gathering Requirements

- *What constitutes “reasonable diligence” in attempting to obtain customer-specific information?* The reasonableness is dependent on the particular circumstances, but asking the customer ordinarily will suffice. Absent any red flags, a broker generally may rely on the customer’s responses. If a customer refuses to provide certain information, even if the member is reasonably diligent, FINRA notes that the firm must carefully consider whether it sufficiently understands the customer to properly evaluate the suitability of a recommendation. Although a member is not required to affirmatively ask customers if there is anything else it should know about them beyond the customer-specific information it seeks to obtain, FINRA notes that it is better practice to gain as much relevant information as possible before making recommendations.
- *What if a customer has multiple, inconsistent investment objectives?* A firm must conduct appropriate supervision and meaningful suitability determinations in light of such differences by, for example, clarifying the intent and, if necessary, reconciling how it will handle the different objectives among numerous customer accounts.
- *Can a broker make recommendations based on a customer’s overall portfolio, including investments held at other firms?* The suitability rule applies on a recommendation-by-recommendation basis, though consideration of a customer’s overall portfolio need not be excluded. The suitability rule requires a member to seek to obtain and analyze a customer’s other investments. Where an associated person is aware of the customer’s overall portfolio, he or she is permitted make recommendations based on the overall portfolio if the customer agrees with such an approach. An associated person is not permitted, however, to make assumptions about a customer’s other holdings. Accordingly, a member may not use a portfolio approach when the customer wants each individual recommendation to be consistent with his or her investment profile or particular factors within that profile, when the broker is unaware of the overall portfolio, or when red flags exist indicating that the broker’s information about the customer’s other holdings may be inaccurate.

### Reasonable-Basis Suitability

- *Can a broker who does not understand the risks associated with a recommendation violate the reasonable-basis obligation even if the recommendation is suitable for some investors?* Under the reasonable-basis obligation, a broker must (i) perform reasonable diligence to understand the nature of the recommended security or investment strategy, as well as the potential risks and rewards, and (ii) determine whether the recommendation is suitable for at least some investors based on that understanding. A broker could violate the obligation if he or she did not understand the recommended security or investment strategy, even if the security or investment strategy is suitable for at least some investors. FINRA notes that in recent years, securities and investment strategies have become increasingly complex and, in some cases, risky. Brokers cannot fulfill their suitability responsibilities to customers (including both their reasonable-basis and customer-specific obligations) when they fail to understand the securities and investment strategies they recommend. Firms’ supervisory policies and procedures must be reasonably designed to ensure that their brokers comply with this requirement.

### Quantitative Suitability

- *Is the quantitative suitability obligation under the new rule different from the excessive trading line of cases under the existing rule?* The quantitative suitability obligation under the new rule simply codifies excessive trading cases. Quantitative suitability requires a broker who has control over a customer account to have a reasonable basis for believing that, in light of the customer’s investment profile, a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at [chapman.com](http://chapman.com).

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

© Chapman and Cutler LLP, 2012. All Rights Reserved.