Frequently Asked Questions FINRA Rule 2111 (Suitability)

Introduction

The following frequently asked questions (FAQs) provide guidance on FINRA Rule 2111 (Suitability). This document consolidates the questions and answers in *Regulatory Notices* 12-55, 12-25 and 11-25, organized by topic. New FAQs will be identified when added.

Overview

FINRA Rule 2111 requires, in part, that a broker-dealer or associated person "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 [firm] or associated person to ascertain the customer's investment profile." In general, a customer's investment profile would include the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance. The rule also explicitly covers recommended investment strategies involving securities, including recommendations to "hold" securities. The rule, moreover, identifies the three main suitability obligations: reasonable-basis, customer-specific, and quantitative suitability. Finally, the rule provides a modified institutional-customer exemption.

FAQs

Recommendation

Q1.1. The suitability rule applies only to recommended securities and investment strategies involving securities, but FINRA does not define the term "recommendation" other than to say that it is a facts and circumstances inquiry. What factors determine whether a recommendation has been made for purposes of the suitability rule? [Notice 12-25 (FAQ 2)]

A1.1. Although FINRA does not define the term "recommendation," it has offered several guiding principles that firms and brokers should consider when determining whether particular communications could be viewed as recommendations. FINRA has extensively addressed those guiding principles in past *Regulatory Notices*, and cases have applied them to specific facts.[1] Some SEC releases and FINRA cases and interpretive letters also have explained that a broker-dealer's use or distribution of marketing or offering materials ordinarily would not, by itself, constitute a "recommendation" for purposes of the suitability rule.[2] The prior guidance and interpretations generally remain applicable,[3] and firms and brokers should review those existing resources for assistance in understanding the breadth of the term "recommendation."

Q1.2. FINRA has stated that the new suitability rule does not broaden the scope of implicit recommendations applicable to the predecessor rule. What are the conditions under which an implicit recommendation can trigger the suitability rule? [Notice 12-25 (FAQ 3)]

A1.2. FINRA and the SEC have recognized that certain actions constitute implicit recommendations that can trigger suitability obligations. FINRA and the SEC have held, for example, that brokers who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule.[4] Although such holdings continue to act

as precedent regarding those issues, the new rule does not broaden the scope of implicit recommendations. The new rule, for example, does not apply to *implicit* recommendations to *hold* a security or securities. Thus, the new rule's "hold" language would not apply when a broker remains silent regarding security positions in an account. The hold recommendation must be explicit.[5]

Q1.3. Customers sometimes ask broker-dealer call centers whether they may continue to maintain their investments at the firm if, for instance, they want to move from an employer-sponsored retirement account held at the firm to an individual retirement account held at the firm. If a firm's call center informs customers that they are permitted to continue to maintain their investments at the firm under such circumstances, would FINRA consider those communications to be "hold" recommendations triggering application of the new suitability rule? [Notice 12-25 (FAQ 4)]

A1.3. In general, FINRA would not view those communications as "hold" recommendations for purposes of the rule because the firm's call center is not responding to the question of whether the customer should hold the securities, but rather whether the customer can continue to maintain them at the firm.

Q1.4. Section 201(a) of the Jumpstart Our Business Startups Act (JOBS Act)[6] directs the SEC to amend Rule 506 of Regulation D under the Securities Act of 1933 to eliminate the prohibition on general solicitations to the extent that all purchasers are accredited investors. Does the elimination of the general solicitation prohibition mean that broker-dealers no longer have suitability obligations regarding private placements? [Notice 12-25 (FAQ 5)]

A1.4. No. The JOBS Act removes certain marketing impediments but not a broker-dealer's suitability obligations. In that regard, and as explained above in the answer to [FAQ 1.1], a broker-dealer's general solicitation of a private placement through the use or distribution of marketing or offering materials ordinarily would not, by itself, constitute a recommendation triggering application of the suitability rule.[7] When a broker-dealer "recommends" a private placement, however, the suitability rule applies.[8]

Customer

Q2.1. What constitutes a "customer" for purposes of the suitability rule? [Notice 12-55 (FAQ 6(a))]

A2.1. The suitability rule applies to a broker-dealer's or registered representative's recommendation of a security or investment strategy involving a security to a "customer." FINRA's definition of a customer in FINRA Rule 0160 excludes a "broker or dealer."[9] In general, for purposes of the suitability rule, the term customer includes a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer's affiliate or a custodial agent (*e.g.*, "direct application" business,[10] "investment program" securities,[11] or private placements[12]), or using another similar arrangement.[13]

Q2.2. Does the suitability rule apply when a broker-dealer or registered representative makes a recommendation to a potential investor? [Notice 12-55 (FAQ 6(b))]

A2.2. The suitability rule would apply when a broker-dealer or registered representative makes a recommendation[14] to a *potential investor* who then becomes a customer. Where, for example, a registered representative makes a recommendation to purchase a security to a *potential investor*, the suitability rule would apply to the recommendation if that individual executes the transaction through the broker-dealer with which the registered representative is associated or the broker-dealer receives or will receive, directly or indirectly, compensation as a result of the recommended transaction.[15] In contrast, the

suitability rule would not apply to the recommendation in the example above if the *potential investor* does not act on the recommendation or executes the recommended transaction away from the broker-dealer with which the registered representative is associated without the broker-dealer receiving compensation for the transaction.[16]

Customer's Investment Profile – Information Gathering Requirements

Q3.1. Does a firm have to update all customer-account documentation by the suitability rule's implementation date to capture the new "customer investment profile" factors (age, investment experience, time horizon, liquidity needs and risk tolerance) that were added to the existing list (other holdings, financial situation and needs, tax status and investment objectives)?[17] [Notice 11-25 (FAQ 2)]

A3.1. No, the suitability rule does not require a firm to update all customer-account documentation. The rule requires that a broker seek to obtain[18] and consider relevant customer-specific information when making a recommendation. Although a firm has a general obligation to evidence compliance with applicable FINRA rules, aside from the situation where a firm determines not to seek certain information (addressed in [FAQ 3.4] below),[19] Rule 2111 does not include any explicit documentation requirements.[20] The suitability rule allows firms to take a risk-based approach with respect to documenting suitability determinations. For example, the recommendation of a large-cap, value-oriented equity security generally would not require written documentation as to the recommendation. In all cases, the suitability rule applies to recommendations, but the extent to which a firm needs to evidence suitability generally depends on the complexity of the security or strategy in structure and performance and/or the risks involved. Compliance with suitability obligations does not necessarily turn on documentation of the basis for the recommendation. However, firms should understand that, to the degree that the basis for suitability is not evident from the recommendation itself, FINRA examination and enforcement concerns will rise with the lack of documentary evidence for the recommendation. In addition, documentation by itself does not cure an otherwise unsuitable recommendation.

Q3.2. Does a broker-dealer have to seek to obtain all of the customer-specific factors listed in the new rule by the rule's implementation date? [Notice 12-25 (FAQ 15)]

A3.2. No. The rule generally requires a broker-dealer to seek to obtain and analyze the customer-specific factors listed in the rule when making a recommendation to a customer. Accordingly, a broker-dealer could choose to seek to obtain and analyze the customer-specific factors listed in Rule 2111 when it makes new recommendations to customers (regardless of whether they are new or existing customers).[21]

Q3.3. What if a customer refuses to provide certain customer-specific information? [Notice 12-25 (FAQ 17)]

A3.3. Some customers may be reluctant to provide certain types of information to their broker-dealers. A customer, for example, may not want to divulge information about "other investments" held away from the broker-dealer in question. The suitability rule generally requires broker-dealers to use reasonable diligence to seek to obtain and analyze the customer-specific factors listed in the rule. A broker-dealer cannot make assumptions about customer-specific factors for which the customer declines to provide information.[22] Furthermore, when customer information is unavailable despite a broker-dealer's reasonable diligence, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of a recommendation.[23] As with the predecessor rule [NASD Rule 2310], however, the new rule would not prohibit a broker-dealer from making a recommendation in the absence of certain customer-specific factors as long as the firm has enough information about the

customer to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information will depend on the facts and circumstances of the particular case.[24]

Q3.4. Would a firm violate the suitability rule if it makes recommendations to customers for whom it has not obtained all of the customer-specific information listed in FINRA Rule 2111(a)? [Notice 11-25 (FAQ 3)]

A3.4. The essential requirement of this provision is that the member firm or associated person exercise "reasonable diligence" to ascertain the customer's investment profile. In most instances, asking a customer for the information would constitute reasonable diligence. When customer information is unavailable despite a firm's reasonable diligence, however, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of the recommendation. While the rule lists some of the aspects of a typical investment profile, not every factor may be relevant to all situations. Indeed, Supplementary Material .04 states that a member need not seek to obtain and analyze all of the factors if it "has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case." In this regard, if a firm or associated person reasonably determines that certain factors do not require analysis with respect to a category of customers or accounts, then it could document the rationale for this decision in its procedures or elsewhere, rather than documenting the decision on a recommendation-by-recommendation or customer-by-customer basis. For example, a firm may conclude that age is irrelevant regarding all customers that are entities or liquidity needs are irrelevant regarding all customers for whom only liquid securities will be recommended.

The absence of some customer information that is not material under the circumstances generally should not affect a firm's ability to make a recommendation. To meet its suitability obligations, a firm must obtain and analyze enough customer information to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information generally will depend on the facts and circumstances of the particular case, including the nature and characteristics of the product or strategy at issue.

Q3.5. What constitutes "reasonable diligence" in attempting to obtain the customer-specific information? [Notice 12-25 (FAQ 16)]

A3.5. Although the reasonableness of the effort will depend on the facts and circumstances, asking a customer for the information ordinarily will suffice. Moreover, absent "red flags" indicating that such information is inaccurate or that the customer is unclear about the information, a broker generally may rely on the customer's responses. A broker may not be able to rely exclusively on a customer's responses in situations such as the following:

- the broker poses questions that are confusing or misleading to a degree that the information-gathering process is tainted,
- the customer exhibits clear signs of diminished capacity, or
- other "red flags" exist indicating that the customer information may be inaccurate.

Q3.6. In addition to using reasonable diligence to obtain and analyze certain *specific* factors about the customer, the new suitability rule requires a broker to consider "any other information the customer may disclose" in connection with the recommendation. How much of a duty does a firm have to pursue "any other information the customer may disclose" to see if it has suitability implications? Does the firm have a duty, for example, to ask its customers if there is anything else it should know about them when collecting information for suitability purposes? [Notice 12-25 (FAQ 18)]

A3.6. Where a customer discloses information to a broker in connection with the recommendation, the broker must consider that information as part of the suitability analysis. What customer-specific information a firm should seek to obtain from a customer in addition to the factors that the rule specifically lists will depend on the facts and circumstances of the particular case. Although a firm is not required to affirmatively ask customers if there is anything else it should know about them, the better practice is to attempt to gain as much relevant information as possible before making recommendations.

Q3.7. How does FINRA define the terms "liquidity needs," "time horizon" and "risk tolerance" for purposes of the suitability rule? [Notice 11-25 (FAQ 4)]

A3.7. FINRA Rule 2111 does not define the terms. As a general matter, these terms are to be understood commensurate with their meaning in financial analysis. FINRA, however, offers the following guidelines:

- **Liquidity Needs:** The extent to which a customer desires the ability or has financial obligations that dictate the need to quickly and easily convert to cash all or a portion of an investment or investments without experiencing significant loss in value from, for example, the lack of a ready market, or incurring significant costs or penalties.[25]
- **Time Horizon:** "[T]he expected number of months, years, or decades [a customer plans to invest] to achieve a particular financial goal."[26]
- **Risk Tolerance:** A customer's "ability and willingness to lose some or all of [the] original investment in exchange for greater potential returns."[27]

FINRA recognizes that there can be an inverse relationship between an investment time horizon and liquidity needs in that the longer a customer's time horizon, the less the need for liquidity. However, a customer may have a long time horizon, but also may need or want to invest all or a portion of his or her portfolio in liquid assets to pay for unexpected expenses or take advantage of unforeseen opportunities. Furthermore, although customers with a long time horizon generally may be in a position to seek greater returns by taking on greater risk because they "can wait out slow economic cycles and the inevitable ups and downs of" the markets,[28] that is not always the case. Some customers with long time horizons may not desire to take on such risk and others, because of considerations outside their time horizons, are unable to do so.

Q3.8. Does a firm have to use the exact rule terminology when seeking to obtain customer-specific information? [Notice 11-25 (FAQ 6)]

A3.8. No. FINRA is aware that some firms currently ask customers for relevant information without using the exact rule terminology or separately designating factors (*e.g.*, investment objectives that include a risk-tolerance component that is not separately labeled as such). Firms may continue to use such approaches. Firms must attempt to obtain and analyze relevant customer-specific information. Although firms should be capable of explaining how they are doing so and, where appropriate, evidencing that they are doing so, the rule does not dictate use of a specific method or process or of particular terminology.

Q3.9. What is a firm's responsibility when customers indicate that they have multiple investment objectives that appear inconsistent? [Notice 12-25 (FAQ 19)]

A3.9. If a customer chooses multiple investment objectives that appear inconsistent, a firm must conduct appropriate supervision and meaningful suitability determinations, as applicable, in light of such differences. For example, a firm should, among other things, clarify the customer's intent and, if necessary, reconcile and/or determine how it will handle the customer's differing investment objectives.

Q3.10. Can a customer with multiple accounts at a single firm have different investment profiles or investment-profile factors (*e.g.*, objectives, time horizons, risk tolerance) for those different accounts? [Notice 11-25 (FAQ 5)]

A3.10. A customer could proceed in such a manner, but a firm should evidence the customer's intent to use different investment profiles or investment-profile factors for the different accounts. Nothing in this guidance, however, relieves a firm from having to ensure that the investment profiles or factors accurately reflect the customer's decisions. In addition, where a firm allows a customer to use different investment profiles or factors for different accounts rather than using a single customer profile for all of the customer's accounts, a firm could not borrow profile factors from the different accounts to justify a recommendation that would not be appropriate for the account for which the recommendation was made.

Q3.11. Can a broker make recommendations based on a customer's overall portfolio, including investments held at other financial institutions? For instance, does each individual recommendation have to be consistent with the customer's investment profile or can the suitability of a broker's recommendation be judged in light of its consistency with the customer's overall portfolio? [Notice 12-25 (FAQ 21)]

A3.11. The answer depends on the facts and circumstances of the particular case. The suitability rule applies on a recommendation-by-recommendation basis. A suitability analysis of a particular recommendation and consideration of a customer's overall investment portfolio, however, are not mutually exclusive concepts. The new suitability rule (as with the predecessor rule) requires a broker to seek to obtain and analyze a customer's other investments. The rule thus explicitly permits a suitability analysis to be performed within the context of a customer's other investments. Some customers, moreover, desire portfolios made up of securities with different levels of liquidity, risk and time horizons. When a broker is aware of a customer's overall portfolio (including investments held at other financial institutions), the broker is permitted to make recommendations based on the customer's overall portfolio as long as the customer is in agreement with such an approach. Under these circumstances, the suitability of a broker's recommendation may be analyzed on the basis of whether the customer's overall portfolio, considering any changes to the portfolio that flow from the broker's recommendation, aligns with the customer's investment profile.[29]

As noted above in the answer to [FAQ 3.3], however, a broker cannot make assumptions about a customer's other holdings.[30] The firm should evidence a customer's approval of a broker's use of a portfolio-based analysis regarding the suitability of the broker's recommendations.[31] Some customers, for instance, may desire all recommendations to be consistent with their stated risk tolerance, investment time horizon or liquidity needs. Accordingly, a broker may not use a portfolio approach to analyzing the suitability of specific recommendations when:

- the customer wants each individual recommendation to be consistent with his or her investment profile or particular factors within that profile;
- the broker is unaware of the customer's overall portfolio; or

- "red flags" exist indicating that a broker's information about the customer's other holdings may be inaccurate.

Nothing in this guidance, moreover, relieves a firm from having to ensure that a customer's investment profile or factors within that profile accurately reflect the customer's decisions.

Q3.12. Should the investment experience of a guardian, custodian, trustee or similarly situated third party managing an account be taken into consideration when making account recommendations? [Notice 12-25 (FAQ 20)]

A3.12. In many circumstances, the answer is yes. In the case of a trust held in a brokerage account, for instance, the firm should consider the trustee's investment experience with, and knowledge of, various investments and investment strategies. The firm, however, also must consider factors such as the trust's investment objectives, time horizon and risk tolerance to complete the suitability analysis.

It also is important to note that, where an *institutional* customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, Rule 2111(b) makes clear that the factors relevant to determining whether the customer meets the criteria for the institutional-customer exemption will be applied to the agent.

Investment Strategies

Q4.1. What is the scope of the term "strategy" as used in FINRA Rule 2111? [Notice 11-25 (FAQ 7)]

A4.1. The rule explicitly states that the term "strategy" should be interpreted broadly.[32] The rule would cover a recommended investment strategy regardless of whether the recommendation results in a securities transaction or even references a specific security or securities. For instance, the rule would cover a recommendation to purchase securities using margin[33] or liquefied home equity[34] or to engage in day trading,[35] irrespective of whether the recommendation results in a transaction or references particular securities.

The term also would capture an *explicit* recommendation to *hold* a security or securities.[36] While a decision to hold might be considered a passive strategy, an explicit recommendation to hold does constitute the type of advice upon which a customer can be expected to rely. An explicit recommendation to hold is tantamount to a "call to action" in the sense of a suggestion that the customer stay the course with the investment. The rule would apply, for example, when an associated person meets with a customer during a quarterly or annual investment review and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio. The rule, however, would not cover an implicit recommendation to hold.[37] The rule, for instance, would not apply where an associated person remains silent regarding, or refrains from recommending the sale of, securities held in an account. That is true regardless of whether the associated person previously recommended the purchase of the securities, the customer purchased them without a recommendation, or the customer transferred them into the account from another firm where the same or a different associated person had handled the account.[38]

Q4.2. The new suitability rule requires that a recommended investment strategy involving a security or securities must be suitable. Can you provide some examples of what would and would not be considered an "investment strategy" under the rule? [Notice 12-55 (FAQ 7)]

A4.2. Rule 2111 states that the term "investment strategy" is to be interpreted "broadly."[39] However, FINRA would not consider a broker-dealer's or registered representative's recommendation that a customer

generally invest in "equity" or "fixed income" securities to be an investment strategy covered by the rule, unless such a recommendation was part of an asset allocation plan not eligible for the safe-harbor provision in Rule 2111.03 (discussed [below in FAQ 4.7]).[40] The "investment strategy" language would apply to recommendations to customers to invest in more specific types of securities, such as high dividend companies or the "Dogs of the Dow,"[41] or in a market sector, regardless of whether the recommendations identify *particular* securities.[42] It also would apply to recommendations to customers generally to use a bond ladder, day trading, "liquefied home equity,"[43] or margin strategy involving securities, irrespective of whether the recommendations mention *particular* securities.

In addition, the term would capture an *explicit* recommendation to *hold* a security or securities or to continue to use an investment strategy involving a security or securities.[44] The rule would apply, for example, when a registered representative meets (or otherwise communicates) with a customer during a quarterly or annual investment review and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio or to continue to use an investment strategy. However, as explained in FAQ [1.2], the rule would not cover an implicit recommendation to hold.

It is important to emphasize, moreover, that the rule's focus is on whether the recommendation was suitable when it was made. A recommendation to hold securities, maintain an investment strategy involving securities or use another investment strategy involving securities—as with a recommendation to purchase, sell or exchange securities—normally would not create an ongoing duty to monitor and make subsequent recommendations.

Q4.3. Does the new rule's "investment strategy" language cover a registered representative's recommendation involving both a security and a non-security investment? [Notice 12-55 (FAQ 10(a))]

A4.3. The new suitability rule would continue to cover a broker-dealer's or registered representative's recommendation of an "investment strategy" involving both a security and a non-security investment.[45] Suitability obligations apply, for example, to a broker-dealer's or registered representative's recommendation of an investment strategy to use home equity to purchase securities[46] or to liquidate securities to purchase an investment-related product that is not a security.[47]

However, where a broker-dealer's or registered representative's recommendation does not refer to a security or securities, the suitability rule is not applicable. The suitability rule would not apply, for instance, if a registered representative recommends a non-security investment as part of an outside business activity and the customer separately decides on his or her own to liquidate securities positions and apply the proceeds toward the recommended non-security investment.[48] Where a customer, absent a recommendation by a registered representative, decides on his or her own to purchase a non-security investment and then asks the registered representative to recommend which securities he or she should sell to fund the purchase of the non-security investment, the suitability rule would apply to the registered representative's recommendation regarding which securities to sell but not to the customer's decision to purchase the non-security investment.

Q4.4. What is the nature of the obligation under the suitability rule created by a hold recommendation? [Notice 11-25 (FAQ 8)]

A4.4. The new rule does not change the longstanding application of the suitability rule on a recommendation-by-recommendation basis. In general, the focus remains on whether the recommendation was suitable at the time when it was made. Absent an agreement, course of conduct or unusual fact pattern that might

alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.[49]

Q4.5. Does the new rule cover a "hold" recommendation regarding securities that the broker did not originally recommend? Would a broker, for example, be responsible for a hold recommendation involving blue chip stocks that a customer transferred into an account at the broker-dealer? [Notice 12-25 (FAQ 11)]

A4.5. Where a broker did not recommend the original purchase of a security but *explicitly* recommends that the customer subsequently hold that security, the new suitability rule would apply. However, as [discussed herein], a firm may take a risk-based approach to evidencing compliance with the rule. A hold recommendation involving shares of a blue chip stock ordinarily would not present the type of risk, absent unusual facts, that would require a detailed analysis or documentation. Where the hold recommendation involves an overly concentrated position in a security, however, documentation usually would be necessary, even if the broker did not originally recommend the purchase of the security.

Q4.6. What is the scope of the provision in Supplementary Material .03 that excludes from the rule's coverage certain types of strategy-related communications that are educational in nature?[50] [Notice 11-25 (FAQ 9)]

A4.6. What could be considered a "safe-harbor" provision in Supplementary Material .03 is limited in scope. Firms seeking to rely on the provision should take a conservative approach to determining whether a particular communication is eligible for such treatment. Any significant variation from the list in the safe-harbor provision would be subject to regulatory scrutiny. It is important to note, however, that the suitability rule would not apply to a firm's explanation of a strategy falling outside the safe-harbor provision if a reasonable person would not view the communication as a recommendation. Accordingly, the suitability rule would cover a firm's recommendation that a customer purchase securities using margin, whereas the rule generally would not cover a firm's brochure that simply explains the risks and benefits of margin without suggesting that the customer take action.[51]

Q4.7. What is the scope of the safe-harbor provision in Rule 2111.03 regarding a firm's use of an asset allocation model? [Notice 12-25 (FAQ 8)]

A4.7. Rule 2111.03 excludes from the suitability rule's coverage various types of communications that are educational in nature even though they could be considered investment strategies involving securities. The rule states that certain communications "are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities[.]"[52] Specifically, the rule provides a safe harbor for firms' use of "[a]sset allocation models that are (i) based on generally accepted investment theory, (ii) 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 (iii) in compliance with [FINRA Rule 2214] (Requirements for the Use of Investment Analysis Tools), if the asset allocation model is an 'investment analysis tool' covered by [FINRA Rule 2214]."[53]

Under this provision, the suitability rule would not apply, for example, to a general recommendation that a customer's portfolio have certain percentages of investments in equity securities, fixed-income securities and cash equivalents, if the recommendation is based on an asset allocation model that meets the above criteria and the firm does not recommend a particular security or securities in connection with the allocation. The suitability rule also would not apply to a firm's allocation recommendation regarding broad-based market sectors (*e.g.*, agriculture, construction, finance, manufacturing, mining, retail, services,

transportation and public utilities, and wholesale trade).[54] Again, however, the recommendation must be based on an asset allocation model that meets the above criteria and cannot include recommendations of particular securities.

In this regard, firms should note that, as an allocation recommendation becomes narrower or more specific, the recommendation gets closer to becoming a recommendation of particular securities and, thus, subject to the suitability rule, depending on a variety of factors (including the number of issuers that fall within the broker-dealer's allocation recommendation).[55] Accordingly, broker-dealers should assess whether allocation recommendations involving certain types of sub-categories of broader market sectors or even more limited groupings are so specific or narrow that they constitute recommendations of particular securities.[56]

Q4.8. Would a recommendation to maintain an asset mix that was based on an asset allocation model that meets the criteria described in the rule fall within the safe-harbor provision in Rule 2111.03? [Notice 12-25 (FAQ 9)]

A4.8. Yes. The safe-harbor provision in Rule 2111.03 would apply to a recommendation to maintain a generic asset mix based on an asset allocation model that meets the criteria described in the rule if the firm does not explicitly recommend that the customer "hold" the specific securities that make up the allocation.

Reasonable-Basis Suitability

Q5.1. 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? [Notice 12-25 (FAQ 22)]

A5.1. Yes. The reasonable-basis obligation has two components: a broker must (1) perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and (2) determine whether the recommendation is suitable for at least *some* investors based on that understanding.[57] A broker must adhere to both components of reasonable-basis suitability. 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. A broker must understand the securities and investment strategies involving a security or securities that he or she recommends to customers.[58]

The reasonable-basis obligation is critically important because, in recent years, securities and investment strategies that brokers recommend to customers, including retail investors, 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 important requirement.[59]

Q5.2. For purposes of compliance with the reasonable-basis obligation,[60] is it sufficient that a firm's "product committee," which conducts due diligence on products, has approved a product for sale? [Notice 11-25 (FAQ 11)]

A5.2. Although due diligence reviews by such committees can be extremely beneficial,[61] a firm's approval of a product for sale does not necessarily mean that an associated person has complied with the reasonable-basis obligation. Reasonable-basis suitability has two main components: a broker must (1) perform reasonable diligence to understand the potential risks and rewards associated with a recommended security or strategy and (2) determine whether the recommendation is suitable for at least some investors

based on that understanding. A broker can violate reasonable-basis suitability under either prong of the test. That is, even if a firm's product committee has approved a product for sale, an individual broker's lack of understanding of a recommended product or strategy could violate the obligation, notwithstanding that the recommendation is suitable for some investors.[62]

A firm should educate its associated persons on the potential risks and rewards of the products that the firm permits them to recommend. In general, an associated person may rely on a firm's fair and balanced explanation of the potential risks and rewards of a product. However, if the associated person remains uncertain about the potential risks and rewards of a product or has reason to believe that the firm failed to address a particular issue or has done so in an incomplete or inaccurate manner, then the associated person would need to engage in further inquiry before recommending the product.

Quantitative Suitability

Q6.1. Is the quantitative suitability obligation under the new rule any different from the excessive trading line of cases under the predecessor rule? [Notice 12-25 (FAQ 23)]

A6.1. No. The quantitative suitability obligation under the new rule simply codifies excessive trading cases. Quantitative suitability requires a broker who has actual or *de facto* control[63] 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.[64] Factors such as turnover rate,[65] cost-to-equity ratio,[66] and use of in-and-out trading[67] in a customer's account may provide a basis for finding that the activity at issue was excessive.

Acting in a Customer's Best Interests

Q7.1. *Regulatory Notice 11-02* and a recent SEC staff study on investment adviser and broker-dealer sales-practice obligations cite cases holding that brokers' recommendations must be consistent with their customers' "best interests."[68] What does it mean to act in a customer's best interests? [Notice 12-25 (FAQ 1)]

A7.1. In interpreting FINRA's suitability rule, numerous cases explicitly state that "a broker's recommendations must be consistent with his customers' best interests."[69] The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests.[70] Examples of instances where FINRA and the SEC have found brokers in violation of the suitability rule by placing their interests ahead of customers' interests include the following:

- A broker whose motivation for recommending one product over another was to receive larger commissions.[71]
- A broker whose mutual fund recommendations were "designed 'to maximize his commissions rather than to establish an appropriate portfolio' for his customers."[72]
- A broker who recommended "that his customers purchase promissory notes to give him money to use in his business."[73]
- A broker who sought to increase his commissions by recommending that customers use margin so that they could purchase larger numbers of securities.[74]
- A broker who recommended new issues being pushed by his firm so that he could keep his job.[75]

- A broker who recommended speculative securities that paid high commissions because he felt pressured by his firm to sell the securities.[76]

The requirement that a broker's recommendation must be consistent with the customer's best interests does not obligate a broker to recommend the "least expensive" security or investment strategy (however "least expensive" may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests. Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers' interests involved cost-related issues. The cost associated with a recommendation, however, ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.

The customer's investment profile, for example, is critical to the assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. These are all important considerations in analyzing the suitability of a particular recommendation, which is why the suitability rule and the concept that a broker's recommendation must be consistent with the customer's best interests are inextricably intertwined.[77]

Institutional-Customer Exemption

Q8.1. Some third-party vendors have created "Institutional Suitability Certificates" to facilitate firms' compliance with the new institutional-customer exemption in Rule 2111(b). Has FINRA endorsed or approved any of these certificates? [Notice 12-25 (FAQ 24)]

A8.1. No. By way of background, the new suitability rule modifies the institutional-customer exemption that existed under the predecessor rule (NASD IM-2310-3). Rule 2111(b) replaces the previous rule's definition of "institutional customer" with the more common definition of "institutional account" in FINRA's "books and records" rule, Rule 4512(c).[78] "Institutional account" means the account of a bank, savings and loan association, insurance company, registered investment company, registered investment adviser or any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.[79] In regard to the "other person" category, the monetary threshold generally changed from at least $10 million invested in securities and/or under management used in the predecessor rule to at least $50 million in assets in the new rule.[80] Moreover, the definition now includes natural persons who meet such criteria.

In addition to the definitional change, the new institutional-customer exemption focuses on two factors: (1) whether a broker "has a reasonable basis to believe the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities" (a factor used in the predecessor rule), and (2) whether "the institutional customer affirmatively indicates that it is exercising independent judgment" (a new requirement).[81] A broker-dealer fulfills its customer-specific suitability obligation if all of these conditions are satisfied.[82]

Some third-party vendors have created and aggressively marketed proprietary "Institutional Suitability Certificates" to facilitate compliance with the new institutional-customer exemption. FINRA has *not* approved or endorsed any third-party Institutional Suitability Certificates and has *not* contracted with any third-party vendor to create such certificates on FINRA's behalf. FINRA also emphasizes that broker-dealers are not required to use such certificates to comply with the new institutional-customer exemption.

As discussed below in the answer to [FAQ 8.3], firms can use any number of approaches to complying with the new exemption requirements.

Q8.2. Some of the "Institutional Suitability Certificates" that are being marketed do not identify an institutional customer's experience with particular asset classes or types of securities or investment strategies involving a security or securities. Does FINRA expect broker-dealers or institutional customers to provide more specificity? [Notice 12-25 (FAQ 25)]

A8.2. Firms should understand that the use of any such Institutional Suitability Certificate in no way constitutes a safe harbor from the rule. As noted above in the answer to [FAQ 8.1], FINRA has not endorsed or promoted any certificate. What further action a broker-dealer will need to take will depend on the facts and circumstances of the particular case. In general, however, when there is an indication that the institutional customer is not capable of analyzing, or does not intend to exercise independent judgment regarding, *all* of a broker-dealer's recommendations, the broker-dealer necessarily will have to be more specific in its approach to ensuring that it complies with the exemption. A broker-dealer need not automatically use a detailed approach when no such indication exists, although providing at least some level of specificity (even if not required) may help eliminate misunderstandings.

FINRA previously issued written guidance on a customer's *capability* of analyzing risks (a factor used in both the predecessor and new suitability rules).[83] FINRA stated that a broker-dealer may conclude in some cases that a customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product or investment strategy that is the subject of a recommendation, the scope of a broker's customer-specific obligations under the suitability rule would not be diminished by the fact that the broker was dealing with an institutional customer. However, the fact that a customer initially needed help understanding a potential investment or investment strategy need not necessarily imply that the customer did not ultimately develop an understanding.

As to an institutional customer's affirmative indication that it intends to *exercise independent judgment* (a new requirement), Rule 2111.07 states that "an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account." In its response to comments during the rulemaking process, however, FINRA noted that a broker-dealer "is free to decide as a business matter to service only those institutional investors that are willing to make the affirmative indication in terms of all potential transactions for its account."[84]

Q8.3. Does the suitability rule require a broker-dealer to have a hard copy agreement on file reflecting an institutional customer's affirmative indication that it intends to exercise independent judgment? [Notice 12-25 (FAQ 26)]

A8.3. As discussed [below] in the answer to [FAQ 9.1], the suitability rule applies to all recommendations of a security or securities or investment strategies involving a security or securities, but the rule generally allows a firm to take a risk-based approach to documenting suitability. In relation to a customer affirmatively indicating the intention to exercise independent judgment, negative consent will not suffice, but the affirmative indication does not necessarily have to be in writing. A firm may use a risk-based approach to documenting compliance with this provision.

A firm could comply with this requirement, for example, by having an institutional customer indicate in a signed customer agreement or other document that the institutional customer will be exercising

independent judgment in evaluating recommendations or a firm could call its institutional customer, have that discussion, and (if it chooses or circumstances require) document the conversation to evidence the institutional customer's affirmative indication.

Documentation and Supervision Regarding Suitability Obligations

Q9.1. For purposes of using a risk-based approach to documenting compliance with suitability obligations, what types of recommendations does FINRA generally consider complex or potentially risky? [Notice 12-25 (FAQ 12)]

A9.1. As with many obligations under various rules, a firm will need to make some judgment calls on the types of recommendations that it should document under FINRA's suitability rule. FINRA previously stated that, although a firm has a general obligation to evidence compliance with applicable FINRA rules, the suitability rule does not include explicit documentation requirements, except in a situation where a firm determines not to seek certain customer information in the first place.[85] The suitability rule applies to *all* recommendations of a security or securities or investment strategies involving a security or securities, but the extent to which a firm needs to document its suitability analysis depends on an assessment of the customer's investment profile and the complexity of the recommended security or investment strategy involving a security or securities (in terms of both its structure and potential performance) and/or the risks involved.[86]

The recommendation of a large-cap, value-oriented equity security usually would not require documentation. Conversely, the recommendation of a complex and/or potentially risky security or investment strategy involving a security or securities usually would require documentation. Numerous *Regulatory Notices* and cases discuss various types of complex and/or potentially risky securities and investment strategies involving a security or securities. Firms and brokers may want to consult those *Regulatory Notices*[87] and cases[88] when considering the types of recommended securities and investment strategies involving securities that they should document.

Q9.2. What types of "hold" recommendations should firms consider documenting? [Notice 12-25 (FAQ 13)]

A9.2. For "hold" recommendations, [as discussed below in FAQ 9.3,] a firm may want to focus on securities that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component; that have a periodic reset or similar mechanism that could alter a product's character over time; that are particularly susceptible to changes in market conditions; or that are otherwise potentially risky or problematic to hold at the time the recommendations are made.[89]

Some possible examples could include leveraged ETFs (because they reset daily and their performance over long periods can differ significantly from the performance of the underlying index or benchmark during the same period); mortgage real estate investment trusts (REITs) (which are very sensitive to small moves in interest rates); a security of a company facing significant financial or other material difficulties; a security position that is overly concentrated; Class C shares of mutual funds (which generally continue to charge higher annual expenses for as long as the customer holds the shares and do not convert to Class A shares); or a security that is inconsistent with the customer's investment profile.

Q9.3. For purposes of the suitability rule, how should a firm document recommendations to hold in particular and recommendations of strategies more generally? [Notice 11-25 (FAQ 10)]

A9.3. As discussed above, aside from the instances when a firm determines not to seek certain information (addressed in [FAQ 3.4]), FINRA Rule 2111 does not impose explicit documentation requirements. Each firm has a general obligation to evidence compliance with applicable FINRA rules. A firm may use a risk-based approach to evidencing compliance with the suitability rule. In that context, a firm may want to focus on hold recommendations involving securities that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component, that have a periodic reset or similar mechanism that could alter the product's character over time, that are particularly susceptible to changes in certain market conditions, or that are otherwise potentially risky to hold at the time when the recommendations are made. A risk-based approach also may lead a firm to pay particular attention to hold recommendations where, at the time the recommendation is made, a customer's account has a heavy concentration in a particular security or industry sector or the security or securities in question are inconsistent with the customer's investment profile.[90] The same approach applies to other recommended strategies. In general, the more complex and risky the strategy, the more the firm using a risk-based approach should focus on the recommendation.

In regard to the type or form of documentation that may be needed, the facts and circumstances must inform that decision. Consistent with the discussions above, however, the complexity of and risks associated with a particular security or strategy likely will impact the level of documented analysis that is appropriate.

Q9.4. How should a firm document "hold" recommendations? [Notice 12-25 (FAQ 14)]

A9.4. The suitability rule does not prescribe the manner in which a firm must document "hold" recommendations when documentation may be necessary. Some firms may create "hold" tickets and some may add "hold" sections to existing order tickets. Other firms may require emails or memoranda to supervisors or emails or letters to customers copying supervisors. Still other firms may create data fields for entering such information into automated supervisory systems.

These are only examples of how some firms may document "hold" recommendations if necessary. Firms do not have to document or individually approve every "hold" recommendation.[91] As with recommendations of other types of investment strategies or of purchases, sales or exchanges of securities, firms may use a risk-based approach to documenting and supervising "hold" recommendations. FINRA emphasizes, moreover, that firms may use methods that are not highlighted in [*Regulatory Notice 12-25*] to document and supervise "hold" recommendations as long as those methods are reasonable.

Q9.5. What are a broker-dealer's supervisory responsibilities for a registered representative's recommendation of an investment strategy involving both a security and a non-security investment? [Notice 12-55 (FAQ 10(b)]

A9.5. FINRA's supervision rules do not dictate the exact manner in which a broker-dealer must supervise its registered representatives' recommendations of investment strategies involving a security and a non-security investment. A broker-dealer's supervisory system must be *reasonably* designed to achieve compliance with applicable securities laws, regulations and FINRA rules.[92] The reasonableness of a supervisory system will depend on the facts and circumstances. As FINRA has stated previously, "FINRA appreciates that no two [broker-dealers] are exactly alike. [Broker-dealers] have different business models; offer divergent services, products and investment strategies; and employ distinct approaches to complying with applicable regulatory requirements."[93] A broker-dealer can consider a variety of

approaches to identifying and supervising its registered representatives' recommendations of investment strategies involving both a security and a non-security component.

A broker-dealer may use a risk-based approach to supervising its registered representatives' recommendations of investment strategies with both a security and non-security component. For instance, as long as the supervisory system is reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules, a firm could focus on the detection, investigation and follow-up of "red flags" indicating that a registered representative may have recommended an unsuitable investment strategy with both a security and non-security component.[94] A registered representative's recommendation that a customer with limited means purchase a large position in a security might raise a "red flag" regarding the source of funds for such a purchase. Similarly, a registered representative's recommendation that a "buy and hold" customer with an investment objective of income liquidate large positions in blue chip stocks paying regular dividends might raise a "red flag" regarding whether that recommendation is part of a broader investment strategy.

Once a broker-dealer identifies a recommended investment strategy involving both a security and a non-security investment, the broker-dealer's suitability obligations apply to the security component of the recommended strategy[95] but its suitability analysis also must be informed by a general understanding of the non-security component of the recommended investment strategy. In the context of a recommended investment strategy involving a security and an outside business activity, the broker-dealer's general understanding of the outside business activity would be based on the information and considerations required by FINRA Rule 3270.[96]

Finally, broker-dealers must keep in mind that, in addition to suitability and supervisory responsibilities, firms have other regulatory obligations to investigate unusual activity.

Endnotes

1. *See, e.g.,* *Regulatory Notice 11-02,* at 2-3 (discussing FINRA's guiding principles that firms and brokers should consider when determining whether a particular communication could be considered a "recommendation" for purposes of the suitability rule); *Regulatory Notice 10-06*, at 3-4 (providing guidance on recommendations made on blogs and social networking websites); *Notice to Members 01-23* (announcing the guiding principles and providing examples of communications that likely do and do not constitute recommendations); *Michael F. Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *21-27 (Oct. 6, 2008) (applying the guiding principles to the facts of the case to find a recommendation), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir.), *cert. denied*, 130 S.Ct. 333 (2010).

2. *See, e.g.,* SEC Adoption of Rules Under Section 15(b)(10) of the Exchange Act, 32 Fed. Reg. 11637, 11638 (Aug. 11, 1967) (noting that the SEC's now-rescinded suitability rule would not apply to "general distribution of a market letter, research report or other similar material"); Suitability Requirements for Transactions in Certain Securities, 54 Fed. Reg. 6693, 6696 (Feb. 14, 1989) (stating that proposed SEA Rule 15c2-6, which would have required documented suitability determinations for speculative securities, "would not apply to general advertisements not involving a direct recommendation to the individual"); *DBCC v. Kunz*, No. C3A960029, 1999 NASD Discip. LEXIS 20, at *63 (NAC July 7, 1999) (stating that, under the facts of the case, the mere distribution of offering material, without more, did not constitute a recommendation triggering application of the suitability rule), *aff'd*, 55 S.E.C. 551, 2002 SEC LEXIS 104 (2002); *FINRA Interpretive Letter, Mar. 4, 1997* ("[T]he staff agrees that a reference to an investment company or an offer of investment company shares in an advertisement or piece of sales literature would not by itself constitute a 'recommendation' for purposes of [the suitability rule].").

3. The discussions (and examples provided) in previous *Regulatory Notices*, cases, interpretive letters, and SEC releases remain applicable to the extent that they are not inconsistent with Rule 2111.

4. *See, e.g., Rafael Pinchas*, 54 S.E.C. 331, 341 n.22, 1999 SEC LEXIS 1754, at *20 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of [FINRA's suitability rule]."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11, 1992 SEC LEXIS 2750, at *5 n.11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended).

5. FINRA previously responded to questions regarding whether the absence of a sell order in a discretionary account amounts to an implicit hold recommendation covered by the rule. FINRA stated that, *"[t]o the extent that a customer account at a broker-dealer can be discretionary under applicable federal securities laws*, the suitability rule generally would not apply where a firm refrains from selling a security." [*See infra* note 38] (emphasis in original).

6. Pub. L. No. 112-106, 126 Stat. 306 (2012).

7. *See supra* note [2].

8. When analyzing whether a particular communication could be viewed as a recommendation triggering application of the suitability rule, firms should consult the prior guidance cited *supra* at notes [1 and 2].

9. *See* FINRA Rule 0160(b)(4) (Definition of Customer).

10. *See* *Notice to Members 04-72*, at 846 ("The BD of record refers to the broker-dealer identified on a customer's account application for accounts held directly at a mutual fund or variable insurance product issuer. Accounts held in this manner are sometimes referred to as 'check and application,' 'application way,' or 'direct application'...business.").

[11] *Regulatory Notice 08-35*, at 2 (stating that direct participation programs (DPPs) and unlisted real estate investment trusts (REITs) are referred to as "investment programs").

[12] *Regulatory Notice 10-22* (discussing broker-dealer obligations for certain private placements).

[13] Nothing in this guidance shall be construed as altering a broker-dealer's obligations under applicable federal laws, regulations and rules or other FINRA rules, including, but not limited to, Sections 9, 10(b) and 15(c) of the Securities Exchange Act of 1934, Section 17(a) of the Securities Act of 1933, the Bank Secrecy Act, 31 U.S.C. §§ 5311, *et seq.* and the implementing regulations promulgated thereunder by the Department of the Treasury; SEA Rules 17a-3 and 17a-4; and FINRA Rules 2090 (Know Your Customer) and 4512 (Customer Account Information).

[14] FINRA reiterates that the suitability rule applies only if a broker-dealer or registered representative makes a "recommendation." FINRA previously has provided guiding principles that firms and registered representatives could consider when determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule. *See, e.g.*, FAQ [1.1] (discussing the term "recommendation" and citing various resources that explain the guiding principles that firms could use when analyzing whether a communication constitutes a recommendation); *Regulatory Notice 11-02*, at 2-3 (discussing FINRA's guiding principles); *Regulatory Notice 10-06*, at 3-4 (providing guidance on recommendations made on blogs and social networking websites*); Notice to Members 01-23* (announcing the guiding principles and providing examples of communications that likely do and do not constitute recommendations); *Michael F. Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *21-27 (Oct. 6, 2008) (applying the guiding principles to the facts of the case to find a recommendation), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir.), *cert. denied*, 130 S.Ct. 3333 (2010).

[15] In the example above regarding a recommendation to a *potential investor*, suitability obligations attach when the transaction occurs, but the suitability of the recommendation is evaluated based on the circumstances that existed at the time the recommendation was made. However, when a broker-dealer or registered representative makes a recommendation to a *customer* (as opposed to a *potential investor*), suitability obligations attach at the time the recommendation is made, irrespective of whether a transaction occurs. *See* [FAQ 4.1], *Regulatory Notice 11-02*, at 3.

[16] Depending on the facts and circumstances, a registered representative's recommendation to a potential investor also could raise concerns under, among other rules, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices); Rule 2210 (Communications with the Public); and NASD Rule 3040 (Private Securities Transactions of an Associated Person); *see also Dep't of Enforcement v. Salazar*, No. 20100224056, 2012 FINRA Discip. LEXIS 22 (Mar. 12, 2012) (finding that registered representative violated NASD Rules 2310 and 3040 when he recommended unsuitable private securities transactions to investors who were not his firm's customers, received compensation in relation to the transactions and failed to notify his firm of such activity); *Maximo J. Guevara*, 54 S.E.C. 655, 2000 SEC LEXIS 986 (2000) (holding that registered representative violated NASD Rules 2310 and 3040 where he recommended unsuitable securities that were sold away from the firm with which he was associated without providing his firm prior notice of such activities).

[17] *See* FINRA Rule 2111(a).

[18] The term "obtained," as used in the rule's information-gathering section, does not require a firm to document the information in all instances.

[19] *See* FINRA Rule 2111.04 (explaining that a firm that decides not to seek to obtain and analyze information about a customer-specific factor must document its reasonable basis for believing that the factor is not a relevant consideration).

[20] FINRA notes that there are SEC and other FINRA rules that explicitly require specific types of documentation. *See, e.g.*, SEA Rule 17a-3(a)(17)(i)(A) (discussing "books and records" requirements for certain account information, including, among other things, date of birth, employment status, annual income, net worth and investment objectives, regarding an account with a natural person as a customer). *See also* [*Regulatory Notice 11-25*, at 9 n.6].

[21] For an expanded discussion of this issue, *see* [FAQ 3.4]. *See also* [*Regulatory Notice 12-25*, at 18 n.3].

[22] *See DBCC v. Hurni*, No. C07960035, 1997 NASD Discip. LEXIS 15, at *9 (NBCC Mar. 7, 1997) ("A broker has a duty to make recommendations based upon the information he has about his customer, rather than based on speculation."); *see also Jack H. Stein*, 56 S.E.C. 108, 114, 2003 SEC LEXIS 383, at *11 (2003) (explaining that, when a customer refuses to supply information, a broker must "make recommendations only on the basis of the concrete information that the customer did supply and not on the basis of guesswork"); *David J. Dambro*, 51 S.E.C. 513, 516-17, 1993 SEC LEXIS 1521, at *9-10 (1993) (same).

[23] *See* [FAQ 3.4].

[24] *See* [FAQ 3.4].

[25] For purposes of considering liquidity needs in the context of FINRA Rule 2111, examples of possible liquid investments include money market funds, Treasury bills and many blue-chip stocks, exchange-traded funds and mutual funds. FINRA emphasizes, however, that a high level of liquidity does not, in and of itself, mean that the recommended product is suitable for all customers. For instance, some relatively liquid products can be complex and/or risky and therefore unsuitable for some customers. *See, e.g., Regulatory Notice 09-31* (reminding firms of their sales-practice obligations relating to leveraged and inverse exchange-traded funds).

[26] *See* www.sec.gov/investor/pubs/assetallocation.htm.

[27] *Id.*

[28] *Id.*

[29] FINRA also previously stated that a customer with multiple accounts at a single firm could have different investment profiles or investment-profile factors (*e.g.*, objectives, time horizons, risk tolerance) for those different accounts. FINRA cautioned, however, that a firm should evidence a customer's intent to use different investment profiles or factors for the different accounts. In addition, FINRA explained that, where a firm allows a customer to use different investment profiles or factors for different accounts rather than using a single customer profile for all of the customer's accounts, a firm could not borrow profile factors from the different accounts to justify a recommendation that would not be appropriate for the account for which the recommendation was made. *See* [FAQ 3.10].

[30] *See supra* note [22] and cases cited therein.

[31] Firms should note, however, that SEA Rule 17a-3 requires that, for *each* account with a natural person as a customer or owner, a broker-dealer generally must create a record that includes, among other things, the account's investment objectives. *See* SEA Rule 17a-3(a)(17)(i). *See also* [*infra* note 86; *Regulatory Notice 12-25*, at 19 n.12].

[32] *See* FINRA Rule 2111.03.

[33] For certain requirements related to margin, see FINRA Rule 2264.

[34] *See* Notice to Members 04-89 (reminding firms that "recommending liquefying home equity to purchase securities may not be suitable for all investors and that [firms] should perform a careful analysis to determine whether liquefying home equity is a suitable strategy for an investor").

[35] For certain requirements related to day trading, see FINRA Rules 2130 and 2270.

[36] *See* FINRA Rule 2111.03.

[37] *See* FINRA Rule 2111.03. In limited circumstances, FINRA and the SEC have recognized that certain actions constitute implicit recommendations that can trigger suitability obligations. For example, FINRA and the SEC have held that associated persons who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule. *See, e.g., Rafael Pinchas*, 54 S.E.C. 331, 341 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended). Although such holdings continue to act as precedent regarding those issues, the new rule does not broaden the scope of *implicit* recommendations. The new rule does not apply to *implicit* recommendations to *hold*.

[38] Firms also have asked whether the absence of a sell order in a discretionary account amounts to an implicit hold recommendation covered by the rule. *To the extent that a customer account at a broker-dealer can be discretionary under applicable federal securities laws*, the suitability rule generally would not apply where a firm refrains from selling a security. The rule states that it applies to *explicit* recommendations to hold. *See* FINRA Rule 2111.03. Unless the facts indicate that an associated person's failure to sell securities in a discretionary account was intended as or tantamount to an explicit recommendation to hold, FINRA would not view the associated person's inaction or silence in such circumstances as a recommendation to hold the securities for purposes of the suitability rule.

[39] *See* FINRA Rule 2111.03.

[40] *See id*. As described in greater detail in FAQ [4.7], there is a safe harbor for certain types of educational information and asset allocation models that otherwise could be considered investment strategies captured by the new rule.

[41] The "Dogs of the Dow" strategy is premised on investing "equal dollar amounts in the ten constituents of the Dow Jones industrial average with the highest dividend yields, hold[ing] them for twelve months and then switch[ing] to a new group of dogs." Vincent Apicella, *Stock Focus: "Dogs of the Dow" Companies*, Forbes.com (May 29, 2001).

[42] The rule would apply, for instance, to a registered representative's recommendation to a customer to purchase shares of high dividend companies even though the registered representative does not mention a *particular* high dividend company.

[43] *See* Notice to Members 04-89 (discussing liquefied home equity).

[44] *See* FINRA Rule 2111.03.

[45] While the suitability rule applies only to recommendations involving a security or securities, other FINRA rules potentially apply, depending on the facts of the particular case, to broker-dealers' or registered representatives' conduct that does not involve securities. *See, e.g.,* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 3270 (Outside Business Activities of Registered Persons); Rule 2210 (Communications with the Public); *see also Ialeggio v. SEC*, No. 98-70854, 1999 U.S. App. LEXIS 10362, *4-5 (9th Cir. May 20, 1999) (holding that FINRA's requirement that registered

representatives act in a manner consistent with just and equitable principles of trade applies to all unethical business conduct, regardless of whether the conduct involves securities); *Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996) (same); *Robert L. Wallace*, 53 S.E.C. 989, 995, 1998 SEC LEXIS 2437, at *13 (1998) (emphasizing, in an action involving viatical settlements, that Rule 2210 is "not limited to advertisements for securities, but provide[s] standards applicable to all [broker-dealer] communications with the public").

[46] FINRA made similar points regarding recommended investment strategies on several occasions under the predecessor suitability rule. FINRA explained in one instance under the predecessor rule that "recommending liquefying home equity to purchase securities may not be suitable for all investors. [Broker-dealers or registered representatives] should consider not only whether the recommended investments are suitable, but also whether the strategy of investing liquefied home equity in securities is suitable." *Notice to Members 04-89*, at 3. *See also Donna M. Vogt*, AWC No. EAF0400730002 (Feb. 21, 2007) (barring registered representative for, among other things, recommending to ten customers, many of whom were nearing retirement, that they obtain home equity loans and use the proceeds to purchase securities, without considering whether such recommendations were suitable for such customers in light of their financial situation and needs); *James A. Kenas*, AWC No. C3B040001 (Jan. 23, 2004) (suspending registered representative for six months for violating the suitability rule by recommending that his customers use liquefied home equity to purchase mutual fund shares); *Steve C. Morgan*, AWC No. C3A040016 (Mar. 9, 2004) (suspending registered representative for six months and ordering him to pay restitution of more than $15,000 for recommending that a retired couple use liquefied home equity to purchase a variable annuity).

[47] *See Notice to Members 05-50*, at 5 ("[R]ecommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender[s] are for the purpose of funding the purchase of an unregistered [equity indexed annuity].").

[48] FINRA Rule 3270.01 (Outside Business Activities of Registered Persons) requires a broker-dealer, upon receipt of a registered person's written notice of a proposed outside business activity, to consider whether the proposed activity will "interfere with or otherwise compromise the registered person's responsibilities to the [broker-dealer or the broker-dealer's] customers or be viewed by customers or the public as part of the [broker-dealer's] business...." *Id.* In addition, the broker-dealer "must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including[,] where circumstances warrant, prohibiting the activity." *Id.* A broker-dealer "also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirement of NASD Rule 3040" (Private Securities Transactions of an Associated Person). *Id.* Furthermore, a broker-dealer "must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1)." *Id.*

[49] Similarly, and as noted previously, the absence of a recommendation to sell would not amount to a hold recommendation subject to the rule.

[50] *See* FINRA Rule 2111.03.

[51] *Regulatory Notice 11-02* discusses several guiding principles that are relevant to determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule.

[52] Nonetheless, FINRA has stated that the safe-harbor provision would be strictly construed. *See* [FAQ 4.6].

[53] FINRA Rule 2111.03. [FINRA Rule 2214 replaced NASD IM-2210-6 (Requirements for the Use of Investment Analysis Tools)]. *See* 77 Fed. Reg. 20452 (Apr. 4, 2012). As discussed above in the answer

to [FAQ 4.7], Rule 2111.03 provides a safe harbor for firms' use of asset allocation models that are, among other things, based on "generally accepted investment theory." These models often take into account the historic returns of different asset classes over defined periods of time. FINRA expects a firm to be capable of explaining how an asset allocation model that it uses is consistent with generally accepted investment theory.

[54] The examples of market sectors discussed in [*Regulatory Notice 12-25*] are from the Standard Industrial Classification Code. *See* SEC Division of Corporation Finance: Standard Industrial Classification.

[55] When a broker-dealer recommends an allocation strategy that includes an allocation in fixed-income securities, FINRA recognizes that a number of additional factors would be relevant in determining if the broker-dealer has "recommended" particular debt securities. A firm's analysis of whether the identification of a more limited universe of fixed-income securities constitutes a recommendation of particular securities may, depending on the facts and circumstances, differ from its assessment regarding equity securities. The issuers' identities and creditworthiness are important information in determining whether to purchase a debt security, but there may be other factors that affect the pricing and any decision to invest in specific debt securities. Moreover, the relative importance of the issuers to other factors in making fixed-income investment decisions varies depending on the total mix of the relevant facts and circumstances. Thus, identifying a more limited universe of debt issuers may not constitute a recommendation if such issuers have many debt securities outstanding, of many maturities, and having distinct structures or features.

[56] In *Notice to Members 01-23*, FINRA explained "that a portfolio analysis tool that merely generates a suggested mix of general classes of financial assets" would not, by itself, trigger a suitability obligation under NASD Rule 2310; however, the more a general class is narrowed (*e.g.*, by providing a list of issuers that fit within the class), the more likely such a communication would be considered a "recommendation." *Id.* at 6 n.15. Firms should use a similar approach to analyzing whether particular recommendations are eligible for the Rule 2111.03 safe-harbor provision.

[57] FINRA Rule 2111.05(a). The new rule explains that, "[i]n general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the [broker-dealer's] familiarity with the security or investment strategy. A [broker-dealer's] reasonable diligence must provide [it] with an understanding of the potential risks and rewards associated with the recommended security or strategy." *Id.*

[58] That is true under case law addressing the predecessor suitability rule as well. *See Richard G. Cody*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862, at *30-32 (May 27, 2011) (stating that a broker can violate reasonable-basis suitability by failing to perform a reasonable investigation of the recommended product and to understand its risks even though the recommendation is otherwise suitable) [*aff'd*, 693 F. 3d 251 (1st Cir. 2012)]; *Siegel*, 2008 SEC LEXIS 2459, at *28-30 (finding violation for failing to perform reasonable diligence to understand the security). *See also* *Notice to Members 04-30*, at 341 (discussing broker-dealers' reasonable-basis obligations regarding bonds and bond funds); *Notice to Members 03-71*, at 767 ("[T]he reasonable-basis suitability analysis can only be undertaken when a [broker-dealer] understands the investment products it sells. Accordingly, a [firm] must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.").

[59] FINRA[, in FAQ 5.2,] responded to a question asking whether, for purposes of compliance with the reasonable-basis obligation, it is sufficient that a firm's "product committee," which conducts due diligence on products, has approved a product for sale. FINRA explained that, although due diligence reviews by such committees can be extremely beneficial (*see, e.g.,* *Notice to Members 05-26*), a firm's approval of a product for sale does not necessarily mean that an associated person has complied with the reasonable-basis obligation. "That is, even if a firm's product committee has approved a product for sale, an individual broker's lack of understanding of a recommended product or strategy could violate the obligation, notwithstanding that the recommendation is suitable for some investors." [FAQ 5.2].

FINRA stated that "[a] firm should educate its associated persons on the potential risks and rewards of the products that the firm permits them to recommend. In general, an associated person may rely on a firm's fair and balanced explanation of the potential risks and rewards of a product." *Id.* FINRA cautioned, however, that, "if the associated person remains uncertain about the potential risks and rewards of a product, or has reason to believe that the firm failed to address a particular issue or has done so in an incomplete or inaccurate manner, then the associated person would need to engage in further inquiry before recommending the product." *Id.*

[60] *See* FINRA Rule 2111.05(a).

[61] *See, e.g.,* Notice to Members 05-26 (recommending best practices for reviewing new products).

[62] *See* FINRA Rule 2111.05(a). This position is consistent with requirements under the previous suitability rule. In *Dep't of Enforcement v. Siegel,* for instance, FINRA's National Adjudicatory Council explained that a "recommendation may lack 'reasonable-basis' suitability if the broker: (1) fails to understand the transaction, which can result from, among other things, a failure to conduct a reasonable investigation concerning the security; or (2) recommends a security that is not suitable for any investors." *Dep't of Enforcement v. Siegel,* No. C05020055, 2007 NASD Discip. LEXIS 20, at *38 (NAC May 11, 2007), *aff'd,* Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459 (Oct. 6, 2008), *aff'd in relevant part,* 592 F.3d 147 (D.C. Cir. 2010), *cert. denied,* 2010 U.S. LEXIS 4340 (May 24, 2010).

[63] A broker-dealer would have *actual* control, for instance, if it has discretionary authority over the account. *See Peter C. Bucchieri*, 52 S.E.C. 800, 805 n.11, 1996 SEC LEXIS 1331, at *12 n.11 (1996). A broker-dealer would have *de facto* control over an account if the customer routinely follows the broker-dealer's advice "because the customer is unable to evaluate the broker's recommendations and [to] exercise independent judgment." *Harry Gliksman*, 54 S.E.C. 471, 475, 1999 SEC LEXIS 2685, at *7 (1999).

[64] FINRA Rule 2111.05(c).

[65] Turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." *Pinchas*, 54 S.E.C. at 339-40 n.14, 1999 SEC LEXIS 1754, at *17 n.14. Turnover rates between three and six may trigger liability for excessive trading. *See Cody*, 2011 SEC LEXIS 1862, at *48 (finding turnover rate of three provided support for excessive trading); *Dep't of Enforcement v. Stein*, No. C07000003, 2001 NASD Discip. LEXIS 38, at *17 (NAC Dec. 3, 2001) ("Turnover rates between three and five have triggered liability for excessive trading"). A turnover rate greater than six creates a presumption that the trading was excessive. *See Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 (6th Cir. 1990); *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1502 (11th Cir. 1985).

[66] The cost-to-equity ratio represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses." *Pinchas*, 54 S.E.C. at 340, 1999 SEC LEXIS 1754, at *18. Cost-to-equity ratios as low as 8.7 have been considered indicative of excessive trading, and ratios above 12 generally are viewed as very strong evidence of excessive trading. *See Cody*, 2011 SEC LEXIS 1862, at *49 & *55 (finding cost-to-equity ratio of 8.7 percent excessive); *Thomas F. Bandyk*, Exchange Act Rel. No. 35415, 1995 SEC LEXIS 481, at *2-3 (Feb. 24, 1995) ("His excessive trading yielded an annualized commission to equity ratio ranging between 12.1% and 18.0%.").

[67] In-and-out trading refers to the "sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities." *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983). A broker's use of in-and-out trading ordinarily is a strong indicator of excessive trading. *Id.*

[68] *See* Regulatory Notice 11-02, at 7 n.11; *SEC Staff Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, at 59 (Jan. 2011) (IA/BD Study). *See also* [Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability), 75 Fed. Reg. 52562, 52567 (Aug. 26, 2010)].

[69] *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006) [, *aff'd*, 304 F. App'x 883 (D.C. Cir. 2008)]; *see also Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'")[, *aff'd*, 416 F. App'x 142 (3d Cir. 2010)]; *Dane S. Faber*, 57 S.E.C. 297, 310, 2004 SEC LEXIS 277, at *23-24 (2004) (stating that a "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces in [them]"); *Wendell D. Belden*, 56 S.E.C. 496, 503, 2003 SEC LEXIS 1154, at *10-11 (2003) ("As we have frequently pointed out, a broker's recommendations must be consistent with his customer's best interests."); *Daniel R. Howard*, 55 S.E.C. 1096, 1100, 2002 SEC LEXIS 1909, at *5-6 (2002) (same), *aff'd*, 77 F. App'x 2 (1st Cir. 2003); *Powell & McGowan, Inc.,* 41 S.E.C. 933, 935, 1964 SEC LEXIS 497, at *3-4 (1964) (same); *Dep't of Enforcement v. Evans,* No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at *22 (NAC Oct. 3, 2011) (same); *Dep't of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *19 (NAC May 10, 2010) (same), *aff'd*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011); *Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) ("[A] broker's recommendations must serve his client's best interests[,]" and the "test for whether a broker's recommendation[s are] suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs."); IA/BD Study, *supra* note [68], at 59 ("[A] central aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the best interests of his customer.").

[70] *See Epstein,* 2009 SEC LEXIS 217, at *42 (stating that the broker's "mutual fund switch recommendations served his own interest by generating substantial production credits, but did not serve the interests of his customers" and emphasizing that the broker violated the suitability rule "when he put his own self-interest ahead of the interests of his customers").

[71] *See Belden*, 56 S.E.C. at 504-05, 2003 SEC LEXIS 1154, at *14.

[72] *Epstein*, 2009 SEC LEXIS 217, at *72; *see also Sathianathan*, 2006 SEC LEXIS 2572, at *23.

[73] *Robin B. McNabb*, 54 S.E.C. 917, 928, 2000 SEC LEXIS 2120, at *24 (2000), *aff'd*, 298 F.3d 1126 (9th Cir. 1990).

[74] *See Stephen T. Rangen*, 52 S.E.C. 1304, 1311, 1997 SEC LEXIS 762, at *19 (1997).

[75] *See Curtis I. Wilson*, 49 S.E.C. 1020, 1022, 1989 SEC LEXIS 25, at *6-7 (1989), *aff'd*, 902 F.2d 1580 (9th Cir. 1990).

[76] *Howard*, 55 S.E.C. at 1100, 2002 SEC LEXIS 1909, at *6-7.

[77] It is important to keep in mind that, in addition to the suitability rule, FINRA has numerous other investor-protection rules. *See, e.g.,* FINRA Rule 2010 (requiring that a broker-dealer, "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade"); FINRA Rule 2020 (prohibiting use of manipulative, deceptive or other fraudulent devices); FINRA Rule 2090 (effective July 9, 2012) (requiring broker-dealers to use reasonable diligence, in regard to the opening and maintenance of every account, to know and retain the essential facts concerning every customer to effectively service customer accounts, act in accordance with any special handling instructions, understand the authority of each person acting on behalf of customers, and comply with

applicable laws, regulations, and rules); FINRA Rule 2330 (imposing heightened suitability, disclosure, supervision, and training obligations regarding variable annuities); FINRA Rule 2360 (requiring heightened account opening and suitability obligations regarding options); FINRA Rule 2370 (requiring heightened account opening and suitability obligations regarding securities futures); NASD Rule 2210 (recently approved as FINRA Rule 2210, *see* 77 Fed. Reg. 20452 (Apr. 4, 2012)) (requiring broker-dealers' communications with the public to, among other things, be fair and balanced, include material information, be free from exaggerated, false or misleading statements or claims, and, as to certain communications, be approved prior to use by a principal and/or filed with FINRA); NASD Rule 3010 (imposing supervisory obligations); FINRA Rule 5310 (requiring broker-dealers to provide best execution). Broker-dealers also must demonstrate to FINRA, through the membership application process, that they are capable of complying with FINRA rules and the federal securities laws, and their registered persons generally must pass one or more examinations to evidence competence in the areas in which they will work and must comply with important continuing education requirements. *See, e.g.,* NASD Rules 1014, 1021 and 1031, and FINRA Rule 1250. These (and many other) FINRA rules provide broad and significant protections to investors. FINRA BrokerCheck®, moreover, allows investors to review the professional and disciplinary backgrounds of firms and brokers online.

78 *See* FINRA Rule 2111(b).

79 *See* FINRA Rule 4512(c).

80 *Compare* FINRA Rules 2111(b) and 4512(c) *with* NASD IM-2310-3.

81 FINRA Rule 2111(b).

82 FINRA Rule 2111(b). The institutional-customer exemption does not apply to reasonable-basis and quantitative suitability. *See id.; Regulatory Notice 11-02*, at 4-5. Quantitative suitability likely will apply in more limited circumstances with regard to institutional customers than it does as to retail customers. The factors that must exist for an institutional customer to qualify for the exemption may, depending on the facts, negate some of the elements relevant to a showing of a broker's "control" over the account. That will not always be the case, however. *See Pryor, McClendon, Counts & Co.*, Exchange Act Rel. No. 45402, 2002 SEC LEXIS 284, at *20-21 & n.10 (Feb. 6, 2002) (holding that the defendant broker "controlled" the account because he essentially was a co-conspirator with the institutional customer's investment officer, who was authorized to place orders for the institutional customer's account).

83 *See Regulatory Notice 11-02,* at 8 n.24.

84 FINRA Response to Comments, Oct. 21, 2010, at 10.

85 *See* [*Regulatory Notice 12-25,* at 18 n.3].

86 Firms should keep in mind, however, that SEA Rule 17a-3 requires that, for each account with a natural person as a customer or owner, a broker-dealer must create a record that includes, among other things, the customer's or owner's name, date of birth, employment status, annual income, and net worth, as well as the account's investment objectives. *See* SEA Rule 17a-3(a)(17)(i)(A). SEA Rule 17a-3 also states that the broker-dealer must furnish such customer or owner a copy of the required account record information or alternative document with all information required by SEA Rule 17a-3(a)(17)(i)(A), including an explanation of any terms regarding investment objectives, for verification within 30 days of account opening and at least once every 36 months thereafter. *See* SEA Rule 17a-3(a)(17)(i)(B)(1). "For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record information required under paragraph (a)(17)(i)(A) of [the Rule] shall excuse the member, broker or dealer from obtaining that required information." SEA Rule 17a-3(a)(17)(i)(C). The account record requirements in paragraph (a)(17)(i)(A) of the Rule apply only to accounts for which the broker or

dealer is, or within the past 36 months has been, required to make a suitability determination. *See* SEA Rule 17a-3(a)(17)(i)(D).

87 *See, e.g.,* Regulatory Notice 12-03 (providing guidance to broker-dealers on supervision and suitability obligations for various complex products); Regulatory Notice 11-15 (providing guidance on low-priced equity securities in customer margin and firm proprietary accounts); Regulatory Notice 10-51 (reminding broker-dealers of their sales practice obligations for commodity futures-linked securities); Regulatory Notice 10-22 (discussing broker-dealer obligations when participating in private offerings); Regulatory Notice 10-09 (reminding broker-dealers of sales practice obligations with reverse exchangeable securities or reverse convertibles); Regulatory Notice 09-73 (reminding broker-dealers of their sales practice obligations relating to principal-protected notes); Regulatory Notice 09-31 (reminding broker-dealers of sales practice obligations relating to leveraged and inverse exchange-traded funds); Regulatory Notice 08-81 (reminding broker-dealers of their obligations regarding the sale of securities in a high yield environment); Notice to Members 05-59 (providing guidance to broker-dealers on the sale of structured products); Notice to Members 05-18 (issuing guidance on section 1031 tax-deferred exchanges of real property for certain tenants-in-common interests in real property offerings); Notice to Members 03-71 (reminding broker-dealers of obligations when selling non-conventional investments); Notice to Members 03-07 (reminding broker-dealers of their obligations when selling hedge funds); Notice to Members 96-32 (providing best practices when dealing in speculative securities); Notice to Members 93-73 (reminding members of their obligations when selling collateralized mortgage obligations).

88 *See, e.g., Cody*, 2011 SEC LEXIS 1862, at *36-40 (discussing non-investment grade securities); *Wells Fargo Invs., LLC*, AWC No. 2008015651901 (Dec. 15, 2011) (stating that "[r]everse convertibles are complex structured products that combine a debt instrument and put option into one product," the repayment of principal is linked to the performance of an underlying asset, such as a stock, a basket of stocks or an index, which is generally unrelated to the issuer of the note, and at maturity, if the value of the underlying asset has fallen below a certain level, the investor may receive less than a full return of principal); *Chase Invs. Servs. Corp.*, AWC No. 2008015078603 (Nov. 15, 2011) (discussing the potential risk of floating rate loan funds, if substantially invested in secured senior loans that are extended to entities whose credit quality is generally unrated or rated non-investment grade, and the risks of a unit investment trust, if substantially invested in speculative instruments such as non-investment grade "junk" bonds); *Ferris, Baker Watts Inc.*, AWC No. 20070091803 (Oct. 20, 2010) (discussing reverse convertibles exposing investors to risks in addition to those risks associated with investment in bonds and bond funds, and having complex pay-out structures involving multiple variables); *Jeffrey C. Young*, Exchange Act Rel. No. 61247, 2009 SEC LEXIS 4332, at *3-6 (Dec. 29, 2009) (discussing the risks of recommendations to certain municipalities to engage in a trading strategy involving buying and selling the same long-term, zero-coupon United States Treasury Bonds (also known as Separate Trading of Registered Interest and Principal of Securities or "STRIPS") within the same day or days using repurchase agreements (repos) to finance such purchases, which "significantly increased the risks…as repos effectively allowed the accounts to borrow large amounts of money in order to hold larger positions of STRIPS"); *Siegel*, 2008 SEC LEXIS 2459, at *30-32 (holding that recommendations of a private placement were unsuitable where the offering documents contained "conflicting [and] confusing information" and there "was no other information on which a prospective investor could rely to make an investment decision"); *Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *7-10 (Dec. 19, 2008) (explaining why the debentures at issue presented a "high risk" for investors); *Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *21-23 (June 29, 2007) (describing the speculative nature of three low-priced securities at issue); *Faber*, 2004 SEC LEXIS 277, at *25 (discussing speculative nature of the security of a company that "had no revenues and had never showed any profits"); *Jack H. Stein*, 56 S.E.C. 108, 117, 2003 SEC LEXIS 338, at *15 (2003) (focusing, in part, on risks of using margin); *James B. Chase*, 56 S.E.C. 149, 153 & 156-157, 2003 SEC LEXIS 566, at *7-8 & *13 (2003) (discussing speculative nature of the security of "a start-up company whose business consisted of manufacturing and selling a single product" that was "new and had no established or tested market" and emphasizing the risks associated with overly concentrated securities positions); *Larry I. Klein*, 52 S.E.C. 1030, 1032-1034, 1996 SEC LEXIS 2922, at *5-10 (1996) (explaining risks associated with certain foreign currency debt securities); *Clinton H. Holland, Jr.*, 52 S.E.C. 562, 565, 1995 LEXIS 3452, at *9 (1995) (remarking that

securities of companies "with a limited history of operations and no profitability" are speculative); *David J. Dambro*, 51 S.E.C. 513, 515, 1993 SEC LEXIS 1521, at *5 (1993) (discussing risky nature of investing in a company that had a history of operating losses and concentrated its assets in illiquid holdings in other unproven start-up companies in the same industry); *Gordon S. Venters*, 51 S.E.C. 292, 293-94, 1993 SEC LEXIS 3645, at *3-5 (1993) (discussing risky nature of investing in a company when that company "was losing money, had never paid a dividend, and its prospects were totally speculative"); *Patrick G. Keel*, 51 S.E.C. 282, 284, 1993 SEC LEXIS 41, at *5 (1993) ("[O]ptions transactions involve a high degree of financial risk. Only investors who understand those risks, and who are able to sustain the costs and financial losses that may be associated with options trading should participate in the listed options markets."); *F.J. Kaufman and Co.*, 50 S.E.C. 164, 165 n.1, 1989 SEC LEXIS 2376, at *2 n.1 (1989) ("The effect of trading on margin is to leverage any position so that the systematic and unsystematic risks are both greater per dollar of investment.").

[89] [FAQ 9.3].

[90] As discussed in [FAQ 4.4] above, absent an agreement, course of conduct or unusual fact pattern that might alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.

[91] Firms are reminded, however, that copies of all communications relating to their business as such and memoranda of brokerage orders are required to be preserved for three years. *See* SEA Rules 17a-3(a)(6) and 17a-4(b)(1) and (b)(4).

[92] *See* NASD Rule 3010 (Supervision).

[93] *Regulatory Notice 12-25*, at 2.

[94] In *Notice to Members 99-45*, FINRA said that the supervision rule "requires that a [firm's] supervisory system be reasonably designed to achieve compliance with applicable laws and regulations. This standard recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations. However, this standard does require that the system be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business." *Id.* at 295.

[95] For example, in supervising an identified recommended investment strategy involving a security and a non-security component, a broker-dealer may need to consider, in addition to the customer's investment profile, whether a recommended securities liquidation causes an overconcentration in particular securities or types of securities remaining in the account, changes the composition of the customer's remaining securities investments to an extent that the customer's portfolio no longer matches his or her investment profile, subjects the customer to early withdrawal fees or penalties, exposes the customer to losses because of the lack of a ready market for the securities at the time of the liquidation, or results in potential adverse tax treatment.

[96] *See also supra* note [48] and discussion therein.

Note: With this guidance, FINRA attempts to present information in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.