Financial Fraud Law Report

VOLUME 4 **NUMBER 9** **OCTOBER 2012**

The FINANCIAL FRAUD LAW REPORT is published 10 times per year by A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207,
POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. *ISSN 1936-5586*

FINRA Issues Additional Guidance on Its New Suitability Rule

CHRISTINA N. DAVILAS, DAVID C. BOCH, W. HARDY CALLCOTT, AND JOHN R. SNYDER

This article discusses various aspects of recent FINRA guidance, with respect to its new suitability rule, and suggests that member firms should use the recent guidance, with the several concrete examples it provides of circumstances that would be subject to the new suitability rule as a checklist to identify any gaps in the new procedures, systems, and trainings they have prepared, and make changes as appropriate.

FINRA's new suitability rule, Rule 2111, went into effect on July 9, 2012. Since the Securities and Exchange Commission approved the new rule on Nov. 17, 2010, and in response to industry questions, the Financial Industry Regulatory Authority ("FINRA") has issued several regulatory notices providing guidance, including most recently Regulatory Notice 12-25 (May 18, 2012) (and, prior thereto, Regulatory Notices 11-02 (Jan. 2011) and 11-25 (May 2011)).[1] As this guidance demonstrates, there is a fair amount of nuance to FINRA's evolving interpretation of a broker-dealer's suitability obligations.

In its most recent guidance, FINRA makes a number of determinations about specific circumstances in which the suitability rule would apply. These

Christina N. Davilas is a counsel in the Boston office of Bingham McCutchen LLP; David C. Boch is a partner in the firm's Boston office; W. Hardy Callcott is a partner in the firm's San Francisco office; John Snyder is a partner in the firm's Boston office. The authors are members of the firm's Broker-Dealer Practice Group and can be reached at christina.davilas@bingham.com, david.boch@bingham.com, hardy.callcott@bingham.com, and john.snyder@bingham.com, respectively.

Published by A.S. Pratt in the October 2012 issue of the *Financial Fraud Law Report*.

determinations appear to seek to expand significantly FINRA's regulatory authority, and/or are surprising in view of the commonly understood bounds of a broker-dealer's duties, both under the predecessor rule and as anticipated under the new rule. For instance, the recent guidance:

- States that FINRA has jurisdiction over investment strategies with security and non-security components (contrary to the established principle that FINRA lacks jurisdiction over non-securities);
- Provides that the suitability obligation includes a requirement to act in the "best interests of the client," seemingly pre-empting any rulemaking by the SEC pursuant to The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that broker-dealers are subject to a generalized fiduciary duty;
- Says that suitability duties apply to "customers," which it defines as anyone at all who is not a broker-dealer, and thereby covers "informal business relationships," including those involving a "potential investor" who "does not have an account at the firm" (contrary to FINRA's more traditional interpretation of the definition of "customers" within the scope of the new "know your customer" rule[2]);
- Casts doubt on a firm's ability to make any recommendation to a customer who refuses to disclose his investments held outside the firm, and suggests a customer should be able to demand that every single security in an account (as opposed to the portfolio as a whole) meet his or her investment objectives; and
- Suggests that a violation of the suitability rule might be found even when the recommendation was suitable and the registered representative understood the product at the time the recommendation was made, but there is a lack of documentation.

This article discusses these and other select aspects of the guidance, with a particular focus on highlighting concrete examples FINRA has provided of circumstances triggering applicability of the rule, and of its determinations concerning when documentation of the suitability assessment is required. Additionally, this article makes some recommendations to assist member firms as they continue to refine their policies, systems and training programs.[3]

KEY ASPECTS OF THE SUITABILITY RULE

FINRA Guidance States That Advice Must be Specific to be Subject to the Rule, Although the Demonstrative Examples it Provides Suggest Quite General Advice May Come Within its Ambit

The Specificity of the Advice is Relevant to Whether it Constitutes a Recommendation Subject to the Rule

Rule 2111 suitability obligations are triggered by a recommendation to engage in a securities transaction or investment strategy involving securities. While the determination of whether a recommendation to buy, sell, or hold a security has been made is generally straightforward (although it can also be subject to ambiguity), the determination of whether a firm has recommended an "investment strategy" is less so. To make that determination, FINRA advises, firms should apply a paradigm of specificity. FINRA explains that whether a "recommendation" has been made is an objective inquiry and "the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation."[4]

Thus, Regulatory Notice 12-25 explains that "FINRA would not consider a broker's recommendation that a customer generally invest in equities or fixed-income securities to be an investment strategy covered by the rule…."[5] Although such generalized advice should not trigger the applicability of Rule 2111, an investment strategy need not be so specific as to "result[] in a securities transaction or even reference[] a specific security or securities."[6] Rather, "[t]he rule would…apply to recommendations to invest in more specific types of securities, such as high dividend companies or the 'Dogs of the Dow,' or in a particular market sector. It would apply to recommendations generally to use a bond ladder, day trading, 'liquefied home equity,' or margin strategy involving securities…."[7]

The Specificity of the Advice is Relevant to the Availability of the Safe Harbor for Asset Allocation Models and Educational Materials

The specificity of the recommendation is also relevant to determining whether the safe harbor for asset allocation models and educational materials

in Rule 2111.03 applies. By its terms, for the safe harbor to apply, the allocation models or educational materials "cannot include recommendations of particular securities," such as those comprising the asset allocation model. Thus, an explicit recommendation to "hold" the specific securities comprising an asset allocation model would constitute a recommendation outside the scope of the safe harbor.[8] Moreover, even if an investment strategy does not reference a specific security, Rule 2111 may still apply. FINRA advises, "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)."[9]

With respect to this last point, "the number of issuers that fall within the broker-dealer's allocation recommendation" is more pertinent to determining whether an *equity* allocation model constitutes a recommendation subject to Rule 2111, and less so for *fixed-income* allocation models: Regulatory Notice 12-25 provides, "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."[10] In particular, "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."[11]

Regulatory Notice 12-25 further advises, "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."[12] In a similar vein, broker-dealers should review educational materials for the same purpose, i.e., so as not to compromise Rule 2111.03's safe harbor for such materials "so long as they do not include…a recommendation of a particular security or securities." Additionally, firms offering asset allocation models might consider revising such models, where appropriate, to replace specific lists of recommended issuers with broader, more generic recommendations.

Investment Strategies Involving Both a Security and a Non-Security Component Are Now Subject to Rule 2111, Regardless of how Generalized the Advice May Be

Through Rule 2111.03's statement that the rule's reference to an "'investment strategy involving a security or securities'…is to be interpreted broadly," the recent Notice creates a sweeping interpretation of the scope of the suitability rule, which appears contrary to FINRA's prior pronouncements that only specific securities recommendations are subject to the rule.

For example, in Regulatory Notice 12-25, FINRA now states that investment strategies involving both a security and a non-security component are subject to Rule 2111. In the 2009 notice seeking comment on the proposed suitability rule, FINRA asked whether the rule should cover recommendations of non-securities products made in connection with a firm's business.[13] This issue generated many comments, the majority of which opposed the change, including on the basis that FINRA lacks jurisdiction over non-securities products.[14] As explained in the SEC notice seeking comment, FINRA explicitly refrained from adding non-securities products to Rule 2111.[15] Now, FINRA states directly that the new rule does cover a recommendation of an "investment strategy" involving both a security and a non-security, and further states that "other FINRA rules potentially apply."[16]

Regulatory Notice 12-25 provides these examples of hybrid strategies coming within the purview of the rule: "a broker's recommendation of an investment strategy to use home equity to purchase securities or to liquidate securities to purchase an investment-related product that is not a security."[17] As these examples show, the "security" aspect of the hybrid strategy can be remote, yet Rule 2111 may still apply to the advice, including the non-securities component. This marks an attempt at a significant expansion of FINRA's regulatory authority — without FINRA having filed the change in interpretation with the SEC for notice and comment.[18]

The Guidance Announces a New,"Best Interests of the Client" Standard

Rule 2111.05 defines the "suitability" standard as limited to the reasonable-basis, customer-specific, and quantitative suitability obligations. In Regu-

latory Notice 12-25, however, FINRA discusses a "suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests" and "prohibits a broker from placing his or her interests ahead of the customer's interests"[19] — a standard that may be viewed as akin to a fiduciary duty. Historically, unlike investment advisers, broker-dealers under ordinary circumstances have not been subject to a fiduciary duty.[20] Under the Dodd-FrankAct , the SEC is authorized to adopt a fiduciary duty standard for broker-dealers, but no such rule has yet been proposed. Thus, reading a fiduciary duty requirement into the suitability rule marks another attempted significant expansion of FINRA's regulatory authority over broker-dealers, again, without FINRA having followed the prescribed rulemaking procedure.[21]

The Guidance Expands the Scope of Suitability Obligations to Reach Potential Investors

In an unwelcome development for firms attempting to prepare themselves and their registered representatives for Rule 2111's implementation, Regulatory Notice 12-25 states that, for purposes of the suitability rule, a "'customer' clearly would include an individual or entity with whom a broker-dealer has even an *informal* business relationship related to brokerage services, as long as that individual or entity is not a broker or dealer. A broker-customer relationship would arise and the suitability rule would apply, for example, when a broker recommends a security to a *potential* investor, even if that potential investor does not have an account at the firm."[22]

In reaching this conclusion, Notice 12-25 relies on FINRA Rule 0160(b)(4), which, like its predecessor (NASD Rule 0120), defines only what the term "customer" "shall not include": "a broker or dealer." Rule 0160(b)(4) falls far short of defining what the term "customer" *shall include*. By claiming it includes everyone but a broker-dealer, Notice 12-25 charts new territory that is not supported by the text of the new rule or otherwise. Notably, for purposes of the new, "know your customer" rule, FINRA follows traditional interpretations of what it means to be a "customer."[23]

This development marks a potentially vast expansion of FINRA's conception of a member firm's suitability obligations and adds ambiguity and complexity to a firm's efforts to comply with the rule.

FINRA's New Account Application Template, Customized as Appropriate, can Assist Firms in Meeting the "Reasonable Diligence" Requirement and in Clarifying Whether a Portfolio-Based Approach to Suitability Should Apply to the Account

Regulatory Notice 12-25 explains that Rule 2111(a)'s requirement that a member or associated person exercise "reasonable diligence" to ascertain the customer's investment profile (including the several factors listed in Rule 2111), will ordinarily be satisfied by asking a customer for the information.[24] Additionally, Regulatory Notice 12-25 provides that, "absent 'red flags' indicating that such information [provided by the customer] is inaccurate or that the customer is unclear about the information, a broker generally may rely on the customer's response."[25] It further advises that a broker may not be able to rely exclusively on a customer's responses in situations where "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' exists indicating that the customer information may be inaccurate.[26] This raises the question of what obligation a firm has to compare information the customer provides to information on file or otherwise available. It also provides an opportunity for much second-guessing about "red flags."

With respect to Rule 2111.04's statement that firms need to document with specificity those circumstances in which they believe one or more investment profile factors are not relevant, Regulatory Notice 11-25 suggests procedures that would ease this requirement, to a point: "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."[27]

Regulatory Notice 12-25 also advises, "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."[28] Firms should consider adopting and customizing FINRA's New Account Application Template.[29] That Template, among other things, prudently addresses Rule 2111's catch-all investment profile factor by asking customers if there is "any additional information not requested [in the application] that you believe will help us more fully understand your investment profile and identify what types of investments or strategies may be suitable for you."[30]

Implicit in Rule 2111's and its predecessor's inclusion of "other investments" as a factor relevant to a customer's "investment profile" is FINRA's view that a portfolio-based approach to the suitability analysis (i.e., one that takes into account a customer's overall portfolio) is generally preferable to one that only considers the investments in the account at issue. Therefore, firms should consider adopting policies and procedures that direct registered representatives to encourage customers to authorize a portfolio-based approach. In cases in which such authority is granted, Regulatory Notice 12-25 advises that a "firm should evidence a customer's approval of using a portfolio-based analysis."[31] Although the Template does not address the issue, firms should consider customizing the Template to seek approval there for a portfolio-based suitability analysis for retail accounts.

When some customer information is unavailable despite a firm's reasonable diligence, in general a firm is not prohibited from making a recommendation as long as the firm has sufficient information about the customer to have a reasonable basis to believe the recommendation is suitable.[32] However, the recent guidance casts doubt on a firm's ability to make a recommendation if the customer (as many customers do) refuses to disclose his other investments or to provide full and accurate information about his other investments. Regulatory Notice 12-25 advises that "[a] broker cannot make assumptions about a customer's other holdings,"[33] and that a broker may not use a portfolio-based approach when "the broker is unaware of the customer's overall portfolio; or 'red flags'…indicat[e] that a broker's information about the customer's other holdings may be inaccurate."[34] Moreover, the recent guidance suggests that a customer should be able to demand that each and every broker-recommended security in an account (rather than the portfolio viewed as a whole) meet his or her suitability profile through its

directive that a broker may not use a portfolio-based approach when "the customer wants each individual recommendation to be consistent with his or her investment profile or particular factors within that profile."[35]

Although a broker generally may satisfy the obligation to seek information about investments held at other firms by asking the customer for such information, Regulatory Notice 12-25 advises, "In many circumstances, a broker should have actual knowledge of investments held at the firm where the broker is registered…."[36] To that end, the Template asks customers whether they have other investments at the firm.[37] Firms should have systems in place so that when a customer provides an affirmative answer to this question, registered representatives obtain actual knowledge of the customer's other investments held at the firm and incorporate that information into any portfolio-based suitability assessments. Firms should have controls in place to assess whether the respective investment objectives among the accounts are so inconsistent that they require resolution before a portfolio-based approach may be applied.

If a customer with multiple accounts at a single firm has different investment profiles or investment profile factors for those different accounts and wishes to maintain those differences, as FINRA has cautioned, a firm should evidence the customer's intent to use different investment profiles or factors for the different accounts.[38] As FINRA has also cautioned, a firm cannot borrow profile factors from different accounts to justify a recommendation that would not be appropriate for the account for which the recommendation was made.[39]

Finally, in addition to firms' obligation to document a customer's approval of a portfolio-based approach, or a customer's intent to use different investment profiles or factors for different accounts, firms should keep in mind the need to create a record for each account with a natural person as a customer or owner that includes, among other things, the account's investment objectives.[40]

Limitations on the Institutional Account Exemption

Following the approval of the exemption to customer-specific suitability obligations for institutional accounts in certain circumstances, certain third parties, including the Securities Industry and Financial Markets Association ("SIFMA"), created new "Institutional Suitability Certificates" for firms' use

to address the requirement in Rule 2111(b) that "the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations."[41]

In a development that may come as a surprise to many broker-dealers who looked to SIFMA's form in particular as a means of obtaining the benefit of the Rule 2111(b) exemption (where institutional customers are willing to make the requisite affirmation), Regulatory Notice 12-25 states that FINRA "has *not* approved or endorsed any third-party Institutional Suitability Certificates" and that "use of any such Institutional Suitability Certificate in no way constitutes a safe harbor from the rule."[42] FINRA further explains, "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."[43] Additionally, "[a] broker-dealer need not automatically use a detailed approach [i.e., go beyond a certificate] when no such indication exists, although providing at least some level of specificity (even if not required) may help eliminate misunderstandings."[44] Thus, although it may come as some relief to broker-dealers to learn that the certificates will serve their intended function in some circumstances, they may need to consider other procedures addressing those circumstances where the certificates may fall short.

Pursuant to Rule 2111.07, "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." However, Regulatory Notice 12-25 reminds members of FINRA's past pronouncement 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."[45] To the extent such a policy may be untenable, as an alternative, a member may consider declining to recommend those securities or asset classes not covered by an institutional investor's written affirmation. Otherwise, in those cases in which an institutional investor indicates affirmatively that it is exercising indepen-

dent judgment only on a trade-by-trade or asset-class-by-asset-class basis, firms will need to have policies in place so that customer-specific suitability obligations are met on those transactions not covered by the affirmation.

Moreover, even when the institutional account exemption applies, the exemption by its terms covers only the customer-specific suitability obligation. The limited scope of the exemption requires that firms have policies and systems for complying with their reasonable-basis and, if applicable, quantitative obligations with respect to institutional accounts. Notably, in Regulatory Notice 11-02, FINRA emphasized that "quantitative suitability generally would apply only with regard to that portion of an institutional customer's portfolio that the firm controls and only with regard to the firm's recommended transactions."[46]

The Guidance Imposes Heightened Obligations, Including a Documentation Requirement, for Risky or Complex Transactions

In Regulatory Notice 12-25, as well as a variety of other pronouncements, FINRA has made clear that complex products are a current regulatory focus.[47] Among other things, firms should adopt policies and procedures requiring registered representatives to document their compliance with their suitability obligations with respect to any recommendations of complex products. While Regulatory Notice 12-25 explains "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…and/or the risks involved,"[48] it goes on to specify that "the recommendation of a complex and/or potentially risky security or investment strategy involving a security or securities usually would require documentation" of the suitability analysis.[49] Likewise, at FINRA's Annual Conference on May 21, 2012, FINRA's Chairman and CEO Richard Ketchum discussed a firm's suitability obligations relative to complex products, stating that, "before any complex product is offered to a retail client, your financial adviser should be able to write down on a single page why this investment is in the best interests of your client."[50] To that end, firms should consider adopting template forms, including specific forms for various categories of complex products, to assist registered representatives in effectively meeting this documentation requirement.

Separate FINRA guidance explains the categories of securities that FINRA considers to be complex products. Specifically, on Jan. 17, 2012, FINRA issued Regulatory Notice 12-03 regarding a member firm's obligation to impose heightened supervision of retail sales of complex products, and provided the following examples of complex products: asset-backed securities secured by a pool of collateral, unlisted REIT's, investments with an embedded derivative component, products with contingencies in gains or losses, structured notes with "worst of" features, and "investments tied to the performance of markets that may not be well understood by many investors."[51] In its 2012 Regulatory and Examination Priorities Letter, FINRA highlighted the importance of suitability obligations and identified a number of products for which its concerns regarding business conduct and suitability are heightened, including residential mortgage-backed securities and commercial mortgage-backed securities, non-traded REITs, municipal securities, complex exchange-traded products, structured products, and issuers engaging in reverse mergers.[52] Most recently, in a podcast FINRA posted on May 23, 2012 concerning heightened supervision of complex products, FINRA again identified structured products, as well as reverse convertibles, as complex products.[53] Additionally, it can reasonably be inferred from Regulatory Notice 12-25 that FINRA also views leveraged ETFs, mortgage REITs and Class C shares of mutual funds as complex products warranting heightened supervision.[54]

Although retail customers are the focus of both Regulatory Notice 12-03 and Mr. Ketchum's recent comments, firms would be well advised to apply a documentation requirement to recommendations for complex products and strategies to institutional accounts, to comply with their reasonable-basis and quantitative-suitability obligations, and, where no Rule 2111(b) exemption applies, customer-specific suitability obligations.

While identifying the foregoing expansive lists of complex products, FINRA provides only the following examples in the recent guidance of products that are *not* complex, and therefore presumptively not subject to the documentation requirement: "[t]he recommendation of a large-cap, value-oriented equity security usually would not require documentation," and "[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."[55] The absence of fixed-income securities

and mutual funds (aside from Class C shares) is interesting. Notice 12-25 acknowledges that "a firm will need to make some judgment calls on the types of recommendations that it should document."[56] FINRA's largely non-committal approach to identifying non-complex products discourages categorical policies.

In his recent speech, Mr. Ketchum also noted that registered representatives who recommend complex products must understand the products they are recommending so they may make appropriate disclosures to customers about the features of the products and their risks and benefits.[57] Regulatory Notice 12-25 takes this point a step further, stating a "broker could violate the [reasonable-basis] 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"[58] — thus suggesting a possible rule violation even when the security or investment strategy was suitable for the investor to whom it was sold.

While repeatedly suggesting that whether to require documentation of a recommendation may be a "risk-based" decision, FINRA has said, "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."[59] Therefore, it is not clear how much flexibility firms will have in practice. Firms should impress upon their registered representatives that the new rule raises the ante — from a regulatory perspective and a litigation perspective — on the need to document diligently their suitability assessments and their communications with customers generally. Firms should stress the need for registered representatives to make contemporaneous documentation part of their everyday routines.

As a general matter, firms can largely rely on their internal written and electronic materials to educate registered personnel appropriately on the products they sell. In particular, Regulatory Notice 11-25 explains that, "[i]n 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."[60]

To address the increased potential for such uncertainty by registered representatives when complex products and investment strategies are at issue, FINRA has made clear in recent guidance (albeit not in the suitability rule itself) that firms should provide additional training to registered representatives on complex products. In particular, Mr. Ketchum explained, "For this disclosure [to customers about a complex product or investment strategy] to work effectively, it will be equally important that you increase the training provided to your financial advisers to ensure that they fully understand the assumptions underlying the product and what can go wrong as well as right."[61] Likewise, in the podcast FINRA posted two days after Mr. Ketchum's speech, FINRA again recommended heightened training for complex products.[62]

Explicit Recommendations to "Hold" or to Continue an Investment Strategy are Subject to the Rule and are also Subject to a Documentation Requirement in Certain Circumstances

Regulatory Notice 12-25 explains that Rule 2111(a) applies to recommendations to "hold" a security or securities or to continue to use an investment strategy only if the recommendations are "explicit" (as Rule 2111.03 states).[63] Even if a broker did not recommend the original purchase of a security, an explicit "hold" recommendation will be subject to the suitability obligation. For instance, "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 or to continue to use an investment strategy," that "hold" recommendation would be subject to the rule.[64] In contrast, when a firm's call center informs customers that they are permitted to move securities from an employer-sponsored retirement account held at the firm to an individual retirement account held at the firm, 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."[65]

Regulatory Notice 12-25 also states that a recommendation to hold or continue an investment strategy "normally would not create an ongoing duty

to monitor and make subsequent recommendations."[66] Firms should consider revising their procedures to require that associated persons clearly disclose (and document) that their recommendations to "hold" are based on relevant factors known at the time of the recommendation only, and that continued monitoring or recommendations will not occur (if that is the case).

With respect to recommendations to hold, Regulatory Notice 12-25 repeats a theme that appears elsewhere in the guidance: firms may take a "risk-based approach to evidencing compliance with the rule," explaining that "[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…."[67] Additionally, Regulatory Notice 12-25 advises that firms should consider documenting "hold" recommendations concerning "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."[68] It provides as "possible examples" leveraged ETFs, mortgage REITs, a security of a company facing significant financial or other material difficulties, a security position that is overly concentrated, Class C mutual funds shares, and a security that is inconsistent with a customer's investment profile.[69]

Regulatory Notice 12-25 notes that Rule 2111 does not prescribe the manner in which a firm must document "hold" recommendations when documentation may be necessary, although it does provide a non-inclusive list of suggestions.[70] Although firms retain flexibility in determining how "hold" recommendations are documented, to avoid ambiguity and facilitate supervision, their policies and procedures should make clear how the firm expects such recommendations to be documented.

FINRA Endorses a Risk-Based Approach to the Supervision of Recommendations

Regulatory Notice 12-25 advises firms to use a "risk-based approach" not only for documentation requirements for suitability assessments and conversa-

tions with clients, but also for supervision.[71] FINRA's recent podcast addressing heightened supervision of complex products provided the following examples of heightened supervisory procedures and controls firms might consider:

- Adopt procedures to ensure the firm does not recommend a given complex product before it has been "thoroughly vetted" at the firm;
- Adopt procedures to reassess periodically the complex products the firm offers;
- Give special consideration to a customer's financial sophistication when recommending complex products;
- Make the sale of complex products contingent on investment concentration limitations;
- Limit the types of investors to whom they will sell such products, or require pre-qualification for retail investors including special agreements that contain detailed disclosures of a product's risks and require attestations by customers that they understand those risks and want to invest in the product type nonetheless (the podcast adds the caveat that such contracts do not mitigate a firm's responsibility to conduct a customer-specific suitability analysis);
- Prohibit the firm's sales force from recommending some complex products to retail investors whose accounts have not been approved for options trading —especially products with embedded options or derivatives features — or other, comparable procedures; and
- Require supervision by someone specially qualified to oversee recommendations of complex products.[72]

In Regulatory Notice 12-25, FINRA provides three examples of high risk circumstances that may warrant closer supervision. First, "a firm may use a risk-based approach to supervising its brokers' recommendations of investment strategies with both a security and non-security component."[73] Second, "[a] broker'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."[74] Third, "a broker'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."[75]

As firms implement new compliance procedures, systems and trainings, due attention should be given to putting into place adequate supervisory systems, perhaps on an initially heightened basis as personnel adjust to the new requirements. Firms should particularly emphasize supervisory systems designed to detect "red flags" concerning possibly unsuitable recommendations and to supervise whether documentation requirements, where applicable, are being followed.

CONCLUSION

Rule 2111 was originally scheduled to take effect on Oct. 7, 2011, but, following a number of requests by firms that FINRA delay implementation to allow more time to prepare for the change, FINRA postponed implementation to July 9, 2012. In light of FINRA's recent prolific guidance, understanding FINRA's views on the new rule's scope is of paramount importance to provide compliance and to minimize exposure. Firms should use the recent guidance and the several concrete examples it provides of circumstances that would be subject to the new suitability rule as a checklist to identify any gaps in the new procedures, systems and trainings they have prepared, and make changes as appropriate.

NOTES

[1] *Suitability*, Regulatory Notice 12-25 (May 18, 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf; *SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations*, Regulatory Notice 11-02 (Jan. 2011) *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf; *New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations*, Regulatory Notice 11-25 (May 2011) *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf.

[2] FINRA's new "know your customer" rule, Rule 2090, also went into effect on July 9, 2012. That rule has been the subject of far less guidance from FINRA since its announcement. Most pertinently, in Regulatory Notice 11-25, FINRA implied that under Rule 2090 firms generally need not know more about authorized agents beyond their names and "any limits on their authority that the customer establishes and communicates to the member firm." Regulatory Notice 11-25, *supra* note 1 at 2. Additionally, in Regulatory Notice 11-02, FINRA advised firms that a "broker-dealer must know its customers not only at account opening but also throughout the life of its relationship.…As with a customer's investment profile under the suitability rule, a firm should verify the 'essential facts' about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances." Regulatory Notice 11-02, *supra* note 1 at 6 n. 5. Although FINRA did not commit to how often such updates should occur, it did note that Rule 17a-3 under the Securities Exchange Act of 1934 requires broker-dealers to update certain account information every 36 months for accounts where the broker-dealers are required to make suitability determinations. *Id.*

[3] The full text of Rule 2111 is available on FINRA's website at the following link: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

[4] Regulatory Notice 11-02, *supra* note 1 at 3.

[5] egulatory Notice 12-25, *supra* note 1 at 6.

[6] *Id.*

[7] *Id.*

[8] *Id.* at 8.

[9] *Id.* at 7.

[10] *Id.* at 22, n. 41.

[11] *Id.*

[12] Regulatory Notice 12-25, *supra* note 1 at 7.

[13] Regulatory Notice 09-25 (May 2009).

[14] Release No. 34-62718A (Aug. 20, 2010), at 26-27.

[15] *Id.* at 29 ("FINRA acknowledges…that future developments in regulatory restructuring could impact any such proposal. FINRA emphasizes, moreover, that the proposed new suitability rule (including the explicit coverage of recommended strategies and expanded list of the types of information that members must seek to gather and analyze) and the proposed 'Know Your Customer' rule together

provide enhanced protection to investors. Consequently, FINRA will not include explicit references to non-securities products in the rule at this time.")

[16] Regulatory Notice 12-25, *supra* note 1 at 8, 23 n.43.

[17] *Id.*

[18] *See* Securities Exchange Act of 1934 § 19(b)(1), 15 U.S.C. § 78s(b)(1) (2010) (requiring that proposed rule changes be filed with the SEC for notice and comment).

[19] Regulatory Notice 12-25, *supra* note 1 at 3.

[20] *E.g.*, *Lefkowitz v. Smith Barney, Harris Upham & Co.*, 804 F.2d 154, 155 (1st Cir. 1986) (per curiam) ("The district court properly dismissed the breach of fiduciary duty claim…because a simple stockbroker-customer relationship does not constitute a fiduciary relationship in Massachusetts"); *Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998) ("Under New York law, as generally, there is no general fiduciary duty inherent in an ordinary broker/customer relationship.…Such a duty can arise only where the customer has delegated discretionary trading authority to the broker.").

[21] *See* Securities Exchange Act of 1934 § 19(b)(1), *supra* note 18.

[22] Regulatory Notice 12-2, *supra* note 1 at 6 (emphasis in original).

[23] *See supra*, note 2. For example, Rule 2090.01 refers to a customer's "account," and Regulatory Notice states (at 2), "[t]he know-your-customer obligation arises at the beginning of the customer-broker relationship."

[24] Regulatory Notice 12-25, *supra* note 1 at 19, n. 8.

[25] *Id.* at 11.

[26] *Id.*

[27] Regulatory Notice 11-25, *supra* note 1 at 4.

[28] Regulatory Notice 12-25, *supra* note 1 at 12.

[29] FINRA New Account Application Template, *available at* http://www.finra.org/industry/tools/p117268 (providing links to long- and short-form new account application templates).

[30] *Id.* All Sections (long form) at 7.

[31] Regulatory Notice 12-25, *supra* note 1 at 13.

[32] *Id.* at 11.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.* at 19, n. 8.

[37] FINRA New Account Application Template, All Sections (long-form) version,

supra note 29, at 1.
[38] Regulatory Notice 12-25, *supra* note 1 at 27, n. 58.
[39] *Id.*; Regulatory Notice 11-25, *supra* note 1 at 5.
[40] Regulatory Notice 12-25, *supra* note 1 at 27, n. 60 (*citing* Securities and Exchange Act of 1934 Rule 17a-3(a)(17)(i)).
[41] *Institutional Suitability Certificate, available at* http://search.sifma.org/search?q=institutional+suitability+certificate&site=SIFMA&client=SIFMA&proxystylesheet=SIFMA&output=xml_no_dtd.
[42] Regulatory Notice 12-25, *supra* note 1 at 15, 16 (emphasis in original).
[43] *Id.* at 16 (emphasis in original).
[44] *Id.*
[45] *Id.*
[46] Regulatory Notice 11-02, *supra* note 1 at 5.
[47] *See, e.g., Complex Products*, Regulatory Notice 12-03 (Jan. 2012) *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf ("A consistent theme…is that the complexity of a product often necessitates more scrutiny and supervision by a firm.…FINRA…has brought a number of enforcement actions involving complex products charging inadequate supervision, unsuitable recommendations and misleading sales practices.").
[48] Regulatory Notice 12-25, *supra* note 1 at 9.
[49] *Id.*
[50] Remarks by Richard Ketchum at the FINRA Annual Conference (May 21, 2012), available at http://www.finra.org/Newsroom/Speeches/Ketchum/P126481.
[51] Regulatory Notice 12-03, *supra* note 47 at 3–5.
[52] FINRA Annual Regulatory and Examination Priority Letter (Jan. 31, 2012), at 3–4, 6, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p125492.pdf.
[53] Podcast, Heightened Supervision of Complex Products - Part 2 (May 23, 2012), available at http://www.finra.org/Industry/Education/OnlineLearning/Podcasts/Products/P126529.
[54] Regulatory Notice 12-25, *supra* note 1 at 10.
[55] *Id.* at 9.
[56] *Id.*
[57] Remarks by Richard Ketchum, *supra* note 50.
[58] Regulatory Notice 12-25, *supra* note 1 at 14.

[59] Regulatory Notice 11-25, *supra* note 1 at 2, 3, 9.
[60] *Id.* at 8.
[61] Remarks by Richard Ketchum, *supra* note 50.
[62] Podcast, Heightened Supervision of Complex Products - Part 2, *supra* note 53.
[63] Regulatory Notice 12-25, *supra* note 1 at 6. *See also* Regulatory Notice 11-25, *supra* note 1 at 6 n. 20: "The new rule does not apply to *implicit* recommendations to *hold*" (emphasis in original).
[64] Regulatory Notice 12-25, *supra* note 1 at 6.
[65] *Id.* at 5.
[66] *Id.*
[67] *Id.* at 8-9.
[68] *Id.* at 9.
[69] *Id.* at 10.
[70] *Id.* ("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.")
[71] *Id.* at 8.
[72] Podcast, Heightened Supervision of Complex Products - Part 2, *supra* note 53.
[73] Regulatory Notice 12-25, *supra* note 1 at 8.
[74] *Id.*
[75] *Id.*