Barbara Black
Charles Hartsock Professor of Law
Director, Corporate Law Center
University of Cincinnati College of Law

Jill I. Gross
Professor of Law
Director, Pace Investor Rights Clinic
Pace University School of Law

June 29, 2009

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Proposed FINRA Rule 2111

Dear Ms. Asquith:

We are writing to comment on FINRA's Proposed Rule 2111, which would supplant NASD Conduct Rule 2310 and NYSE Rule 405 in the Consolidated FINRA Rulebook. We are law professors who have written and lectured widely about the obligations of broker-dealers to their customers. We also have represented investors in securities arbitrations who have alleged violations of NASD Conduct Rule 2310.

NASD Conduct Rule 2310 imposes on members and associated persons the duty to recommend only suitable securities to customers and is an aspect of FINRA Rule 2010's requirement that members and associated persons observe "high standards of commercial honor." Therefore, we support the concept of incorporating NASD Rule 2310 and the analogous NYSE Rule 405 into the Consolidated FINRA Rulebook, as well as codifying various interpretations regarding the scope of the suitability rule. In particular, we support the language clarifying that the obligation encompasses investment strategies, specifying the information that members must gather and use as part of a suitability analysis, and delineating the three suitability obligations (reasonable basis, customer-specific and quantitative).

Failure to Include NASD 2310 Interpretive Material

However, we are deeply concerned that the proposal appears to eliminate, without explanation, some of the current 2310-2 Interpretive Material and does not appear to be transferring that interpretive material into the Consolidated FINRA Rulebook with Proposed Rule 2111. For example, IM 2310-2 explains to members that FINRA can discipline them for improper sales practices and gives specific examples of common types of broker misconduct, including excessive trading, unauthorized trading, and fraud. This interpretive material is the only place in the NASD Conduct Rules explicitly prohibiting unauthorized trading and has been the basis of enforcement actions for

unauthorized trading.[1] Including some, but not all, of the examples of improper sales practices in the new Rule and Supplementary Material may suggest that the excluded practices are no longer considered improper. While we do not believe that FINRA intends to disavow the substantive content of IM 2310-2, the failure to transfer it into the Consolidated FINRA Rulebook, whether as part of Proposed FINRA Rule 2111 or with FINRA Rule 2010 (as examples of violations of the rule requiring that members observe just and equitable principles of trade in the conduct of its business) would diminish the clarity that the interpretive material provides to members. Thus, we cannot support the replacement of NASD Conduct Rule 2310 unless that interpretive material is transferred into the Consolidated FINRA Rulebook.

Problems with Drafting of Proposed Rule 2111

In addition, we do not support certain specific language of Proposed FINRA Rule 2111 as currently drafted, as we believe that it is not clear in certain places. We itemize below our concerns and suggested edits with respect to both the proposed rule itself and the proposed supplementary material.

Suitability - Proposed 2111(a)

- This subsection consists of one very long sentence, which is confusing as written. We recommend breaking it down into at least two sentences, and re-ordering some of the phrases. The first sentence should start out with the phrase: "When making a recommendation, a member or an associated person must have a reasonable basis to believe...," so it is clear on its face that the requirement applies to a recommendation.

- In the third line, we believe the use of the word "known" leaves a loophole for associated persons to claim they didn't know certain information when they consciously avoided learning it. We believe the standard should be "known or should have known," to more accurately reflect the negligence standard consistently applied in FINRA enforcement actions alleging violations of NASD 2310.[2]

- The second to last line uses the word "reasonable" to modify the information the member or associated person should consider when making recommendations. We strongly believe that "reasonable" is the wrong word in this context, as it suggests that the member or associated person can subjectively determine what information

[1] *See* In the Matter of the Dept. of Enforcement vs. Baxter, 2000 WL 535170 (N.A.S.D. Apr. 19, 2000) (affirming sanction against associated person for unauthorized trading under IM 2310-2).

[2] *E.g.*, Dept. of Market Regulation v. Respondent, Disc. Proceeding No. 2005000191701, 2008 WL 4386776 (N.A.S.D.R. Apr. 30, 2008) (imposing sanctions for 2310 violations when respondent should have known additional information about the customers' financial condition); Dept. of Enforcement vs. James B. Chase, Complaint No. C8A990081, 2001 NASD Discip. LEXIS 30 (Aug. 15, 2001) (finding recommendation unsuitable when respondent should have realized customer would have to liquidate shares in the account to pay a margin call because the account was 100% of her liquid assets).

it/he/she deems worthy of considering, not what a reasonable, securities professional must consider. A better word would be "material" or "useful."

2111 Supplementary Material

- FINRA should re-draft the supplementary material section in the active voice and in plain English, to make it clear which parties have which responsibilities. Unclear, passive sentences include: In .01, "sales efforts must be undertaken"; In .02, "when viewed in isolation,"; "when taken together in light of..."

- The third line of .02 should use the "and/or" convention rather than just "or."

- The 11th line of .02 uses the term "customer's profile," but that term is not defined in the referenced section (2111(a)). We suggest that FINRA add a more precise definition.

- The definition of "quantitative unsuitability" in .02 uses the term "unsuitable." It seems circular to define a type of unsuitability with the word "unsuitable."

Know Your Customer – Proposed 2090

We believe FINRA should replace the word "essential" on the second line of Proposed Rule 2090, as the word used in this context can mean "barebones." We do not believe this is the meaning FINRA intends. We suggest replacing it with the word "material."

Expanding Suitability Obligation To Recommendations of All Investment Products

FINRA also seeks comment on whether it should propose expanding suitability obligations to recommendations of all investment products, services and strategies made in connection with a firm's business, regardless of whether the recommendations involve securities. Increasingly, broker-dealers offer their customers a variety of financial products; in addition, many broker-dealers permit their associated persons to offer their customers financial products as private securities transactions pursuant to NASD Rule 3040 or outside business activities pursuant to NASD Rule 3030. We support a revision of proposed Rule 2111 to include all investment products, services and strategies for the following reasons.

First, in some instances it may be unclear whether the product is a security as defined in the federal securities laws.[3] As a result, associated persons have marketed many types of schemes, including promissory notes, prime bank schemes and ponzi

[3] *See, e.g.,* Complaint, Amer. Equity Life Ins. Co. v. SEC, Case No. 09-1021 (D.C. Cir.) (challenging SEC's adoption of a rule regulating indexed annuities); SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996) (holding that viatical settlements were not securities under federal law).

schemes, to the public, based on promoters' assertions that these schemes did not involve securities.[4]

Second, because financial products have become more complex and difficult for many customers to understand, customers of necessity have come to rely on their brokers' advice for investments and strategies that meet their financial situation and investment objectives. For example, in the wake of an earlier downturn in the equity markets, NASD observed that brokers and retail investors showed increased interest in non-conventional investments (NCIs) that frequently have complex terms and features. It reminded its members that "the fact that an investment is a NCI does not in any way diminish a member's responsibility to ensure that such a product is offered and sold in a manner consistent with the member's general sales conduct obligations."[5]

Finally, and most fundamentally, members and associated persons fail to observe the "high standards of commercial honor and just and equitable principles of trade" required by FINRA Rule 2010 if they recommend any unsuitable financial product, service or strategy to their customers. NASD and FINRA have long recognized that sales efforts must be judged by the Rules' ethical standards, "with particular emphasis on the requirement to deal fairly with the public."[6] Thus, for example, in 2005 NASD expressed concern about the manner in which associated persons were selling unregistered equity-indexed annuities (EIAs) and the absence of adequate supervision of these sales practices.[7] Without seeking to resolve the issue of whether any particular EIA was an insurance product or a security, NASD emphasized that because of the complexity of EIAs a broker may have difficulty determining whether the features of any particular product were suitable for his customer. Accordingly, it encouraged firms to adopt supervisory procedures to protect their customers, including supervision over the suitability analysis and other sales practices associated with the recommendation of unregistered EIAs in the same manner that it supervises the sale of securities. More recently, Richard G. Ketchum, Chairman and CEO of FINRA, has stated that "[i]t has long been urged by FINRA—and it is a personal mission of mine—that America's 90 million investors should receive the same level of protection no matter which financial services or products they select."[8]

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[4] *See* NASD NOTICE TO MEMBERS 01-79 (NASD Reminds Members of Their Responsibilities Regarding Private Securities Transactions Involving Notes and Other Securities and Outside Business Activities) (Dec. 2001).

[5] NASD NOTICE TO MEMBERS 03-71 (Non-Conventional Investments) (Nov. 2003).

[6] IM-2310-2 (Fair Dealing with Customers).

[7] NASD NOTICE TO MEMBERS 05-50 (Equity-Indexed Annuities) (Aug. 2005); *see also* NASD Rule 2212(g)(2) (Telemarketing) (regulating any telephone solicitations "for the purpose of encouraging the purchase or rental of, or investment in, property, goods or services").

[8] *See* Rick Ketchum, Remarks at the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/Speeches/Ketchum/P118889; *see also* Rick Ketchum, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Mar. 26, 2009) (stating that "at the very "least, our system should provide investors with the following protections: ...

In short, a broker is not dealing fairly with his customer if he makes a recommendation of any product, service or strategy without having a reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for his customer. Accordingly, we do not view the proposal as an *expansion* of the brokers' obligations; rather the proposal would make explicit what the SRO Rules have consistently required from members and associated persons. We support a revision of proposed Rule 2111(a) to incorporate explicitly a suitability obligation that is not limited to securities.

Thank you for the opportunity to make these comments.

Sincerely,

Jill Gross

Barbara Black

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every product marketed to a particular investor is appropriate for recommendation to that investor"), available at http://www.finra.org/Newsroom/Speeches/Ketchum/P118298.