

# Regulatory Notice

12-55

## Suitability

### Guidance on FINRA's Suitability Rule

#### Executive Summary

In November 2010, the Securities and Exchange Commission (SEC) approved FINRA Rule 2111 (Suitability), which became effective on July 9, 2012.<sup>1</sup> In May 2012, FINRA issued [Regulatory Notice 12-25](#), which provides guidance on the rule in a “frequently asked questions” (FAQ) format.<sup>2</sup> This *Notice* addresses two issues discussed in [Regulatory Notice 12-25](#): the scope of the terms “customer” and “investment strategy.” In addition, FINRA has created a [suitability Web page](#) that, among other things, will locate in one place questions and answers regarding FINRA Rule 2111.

Questions regarding this *Notice* should be directed to:

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#### Discussion

FINRA Rule 2111 requires, in part, that a broker-dealer or registered representative “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 customer’s investment profile.<sup>3</sup> In [Regulatory Notice 12-25](#), FINRA addressed the scope of the terms “customer” and “investment strategy” in FAQ 6, 7 and 10. The answers to those questions are superseded by the answers provided below in this *Notice*.

### December 2012

#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

#### Key Topics

- ▶ Customer
- ▶ Investment Strategies
- ▶ Outside Business Activities
- ▶ Recommendation
- ▶ Suitability
- ▶ Supervision

#### Referenced Rules and Notices

- ▶ FINRA Rule 0160
- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2020
- ▶ FINRA Rule 2090
- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2210
- ▶ FINRA Rule 3270
- ▶ FINRA Rule 4512
- ▶ NASD Rule 2210
- ▶ NASD Rule 3010
- ▶ NASD Rule 3040
- ▶ NTM 05-50
- ▶ NTM 04-89
- ▶ NTM 04-72
- ▶ NTM 01-23
- ▶ NTM 99-45
- ▶ Regulatory Notice 12-25
- ▶ Regulatory Notice 11-25
- ▶ Regulatory Notice 11-02
- ▶ Regulatory Notice 10-22
- ▶ Regulatory Notice 10-06
- ▶ Regulatory Notice 08-35
- ▶ SEA Rules 17a-3 and 17a-4



Financial Industry Regulatory Authority

## Customer

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Question 6 from [Regulatory Notice 12-25](#) is now 6(a) with a new answer

### Q6(a). What constitutes a “customer” for purposes of the suitability rule?

A6(a). 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.”<sup>4</sup> 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,<sup>5</sup> “investment program” securities,<sup>6</sup> or private placements<sup>7</sup>), or using another similar arrangement.<sup>8</sup>

### New question and answer 6(b)

### Q6(b). Does the suitability rule apply when a broker-dealer or registered representative makes a recommendation to a potential investor?

A6(b). The suitability rule would apply when a broker-dealer or registered representative makes a recommendation<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup>

## Investment Strategy

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Question 7 from [Regulatory Notice 12-25](#) with a new answer

**Q7.** 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?

**A7.** Rule 2111 states that the term “investment strategy” is to be interpreted “broadly.”<sup>12</sup> 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 in FAQ 8).<sup>13</sup> 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,”<sup>14</sup> or in a market sector, regardless of whether the recommendations identify *particular* securities.<sup>15</sup> It also would apply to recommendations to customers generally to use a bond ladder, day trading, “liquefied home equity,”<sup>16</sup> 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.<sup>17</sup> 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 3, 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.

Question 10 from [Regulatory Notice 12-25](#) is now 10(a) with a new answer

**Q10(a). Does the new rule’s “investment strategy” language cover a registered representative’s recommendation involving both a security and a non-security investment?**

A10(a). 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.<sup>18</sup> 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<sup>19</sup> or to liquidate securities to purchase an investment-related product that is not a security.<sup>20</sup>

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.<sup>21</sup>

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.

**New question and answer 10(b)**

**Q10(b). 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?**

A10(b). 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.<sup>22</sup> 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.”<sup>23</sup> 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.<sup>24</sup> 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<sup>25</sup> 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.<sup>26</sup>

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 75 Fed. Reg. 71479 (Nov. 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039); [Regulatory Notice 11-25](#). In addition, the SEC's order approved FINRA Rule 2090 (Know Your Customer), which also became effective on July 9, 2012. *Id.*
2. For purposes of this *Notice*, a reference to a numbered FAQ means the FAQ from [Regulatory Notice 12-25](#).
3. FINRA Rule 2111(a).
4. See FINRA Rule 0160(b)(4) (Definition of Customer).
5. 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.").
6. [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").
7. [Regulatory Notice 10-22](#) (discussing broker-dealer obligations for certain private placements).
8. 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).
9. 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 2 (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).
10. 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 [Regulatory Notice 11-25](#), at 6; [Regulatory Notice 11-02](#), at 3.
11. 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).
  12. See FINRA Rule 2111.03.
  13. See *id.* As described in greater detail in FAQ 8, 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.
  14. 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).
  15. 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.
  16. See [Notice to Members 04-89](#) (discussing liquefied home equity).
  17. See FINRA Rule 2111.03.
  18. 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 *Ialleggio 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").

19. 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).
20. 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].”).
21. 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.*
22. See NASD Rule 3010 (Supervision).
23. *Regulatory Notice 12-25*, at 2.
24. 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.



25. 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.
26. *See also supra* note 21 and discussion therein.