

DECEMBER 17, 2012

FINRA Issues Additional Guidance On The New Suitability Rule, Clarifying The Scope Of Member Firms' And Registered Representatives' Suitability Obligation

A. Introduction

On December 10, 2012, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 12-55, providing updated guidance concerning the new suitability rule. See <http://www.finra.org/Industry/Regulation/Notices/2012/P197436>. Regulatory Notice 12-55 provides guidance with respect to the terms "customer" and "investment strategy" contained in Rule 2111, superseding in certain respects the guidance contained in Regulatory Notice 12-25. This Alert reviews the salient aspects of Regulatory Notice 12-55. Among other things, Regulatory Notice 12-25 limits the extent to which the suitability rule applies to recommendations made to a potential investor, requiring that the potential investor ultimately become a customer. Regulatory Notice 12-55 also clarifies that the suitability rule does not apply to a recommendation of a non-securities investment unless that recommendation in some way implicates a security. The notice also provides member firms with guidance on complying with their responsibility for supervising registered representatives' recommendations of an investment strategy which involves both a security and a non-security investment. Regulatory Notice 12-25 thus eliminates some of the uncertainty concerning the scope of the terms "customer" and "investment strategy" that was created by the guidance offered by Regulatory Notice 12-25.

B. FINRA's New Suitability Rule And Regulatory Notice 12-55

FINRA's new suitability rule, Rule 2111, requires *inter alia* 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 information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile." FINRA Rule 2111(a). The new suitability rule went into effect on July 9, 2012. In May 2012, FINRA issued Regulatory Notice 12-25 for the purpose of providing guidance on the new rule, set forth in a "Frequently Asked Questions" ("FAQ") format. Among other things, Regulatory Notice 12-25 addressed the scope of the terms "customer" and "investment strategy." See Regulatory Notice 12-25, FAQ Nos. 6, 7 and 10.

Regulatory Notice 12-55, issued on December 10, 2012, clarifies, and in certain respects supersedes, the guidance set forth in Regulatory Notice 12-25 with respect to the scope of the terms "customer" and "investment strategy." Among other things, Regulatory Notice 12-55 limits the circumstances in which investment recommendations made to a potential investor can become subject to the suitability rule. Regulatory Notice 12-25 had suggested that the new suitability rule would broadly apply to recommendations made to members of the public with whom no customer

■

Regulatory Notice 12-55 substantially scales back the application of the suitability rule to such recommendations by clarifying that the rule “would apply when a broker-dealer or registered representative makes a recommendation to a *potential investor* who then becomes a customer.”

■

relationship had been established. Specifically, FINRA advised in Regulatory Notice 12-25 that 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.” Regulatory Notice 12-25, Answer to FAQ No. 6 (emphasis in original). Regulatory Notice 12-25 had advised further that “[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.” *Id.* Regulatory Notice 12-55 substantially scales back the application of the suitability rule to such recommendations by clarifying that the rule “would apply when a broker-dealer or registered representative makes a recommendation to a *potential* investor who then becomes a customer.” Regulatory Notice 12-55, Answer to FAQ No. 6(b) (emphasis in original). For example, Regulatory Notice 12-55 explains, where “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.” *Id.* (emphasis in original). By 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.” *Id.* (emphasis in original).

Regulatory Notice 12-55 also makes clear that not every recommendation that a registered representative makes constitutes an “investment strategy” subject to the suitability rule, notwithstanding Rule 2111’s mandate that this term be interpreted “broadly.” FINRA Rule 2111.03. In this regard, Regulatory Notice 12-55 both reconfirms certain aspects of the guidance provided in Regulatory Notice 12-25 concerning the scope of the term “investment strategy” and provides new guidance on this subject matter. First, Regulatory Notice 12-55 reconfirms that “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...” Regulatory Notice 12-55, Answer to FAQ No. 7. Second, Regulatory Notice 12-55 reconfirms that recommendations that a customer “invest in more specific types of securities, such as high dividend companies or the ‘Dogs of the Dow,’ or in a market sector, regardless of whether the recommendations identify *particular* securities,” by contrast, would constitute investment strategies for purposes of Rule 2111, as would recommendations “generally to use a bond ladder, day trading, ‘liquefied home equity,’ or margin strategy involving securities, irrespective of whether the recommendations mention *particular* securities.” *Id.* (emphasis in original). Third, Regulatory Notice 12-55 reconfirms that “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.” Regulatory Notice 12-55, Answer to FAQ No. 10(a).

Regulatory Notice 12-55 also limits the scope of the term “investment strategy” by providing that the suitability rule would not apply “where a broker-dealer’s or registered representative’s recommendation does not refer to a security or securities.” Regulatory Notice 12-55, Answer to FAQ No. 10(a). Thus, the suitability rule “would not apply ... 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.” *Id.* By contrast, “[w]here 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 a 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.” *Id.*

Finally, Regulatory Notice 12-55 addresses the supervisory responsibilities of a broker-dealer for “a registered representative’s recommendation of an investment strategy involving both a security and a non-security investment.” Regulatory Notice 12-55, FAQ No. 10(b). Regulatory Notice 12-55 does not set forth any specific requirements for the supervision of such recommendations, observing that “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.” Regulatory Notice 12-55, Answer to FAQ No. 10(b). The notice advises, however, that 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,” including a “risk-based approach to supervising” such recommendations. *Id.* One such risk-based approach would be for the broker-dealer to “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.” *Id.* Using such an approach, “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....” *Id.* Regulatory Notice 12-55 emphasizes, however, that a broker-dealer’s suitability analysis also must be informed by a general understanding of the non-security component of the recommended investment strategy.” *Id.*

C. Conclusion

Regulatory Notice 12-55 provides member firms and their registered representatives with useful clarification concerning the application of the new suitability rule, and imposes sensible limitations on the scope of the suitability obligation. Regulatory Notice 12-55 confirms that member firms and registered representatives do not have a suitability obligation for recommendations made to potential investors with whom no account relationship exists unless the potential investors become customers. The Notice thus eliminates the potentially limitless suitability obligation of member firms for such recommendations that was created by Regulatory Notice 12-25. Nor do member firms and registered representatives have a suitability obligation for recommendations

■

Regulatory Notice 12-55 provides member firms and their registered representatives with useful clarification concerning the application of the new suitability rule, and imposes sensible limitations on the scope of the suitability obligation

■

SECURITIES LAW ALERT

involving non-securities investments unless the investments somehow implicate securities recommendations. Finally, Regulatory Notice 12-55 makes clear that member firms need to have an understanding of the non-securities component of a recommended investment strategy in order to properly discharge their supervisory obligation with respect to the securities component of the strategy. The guidance provided by Regulatory Notice 12-55 should thus help facilitate the ability of member firms and registered representatives to comply with their suitability obligations as they now exist under the new suitability rule. ■

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

*David J. Libowsky, Esq.
dlibowsky@bressler.com
973-660-4423*

The information contained in this Client Alert is for general informational purposes only and is neither presented nor intended to constitute legal advice or a legal opinion as to any particular matter. The reader should not act on the basis of any information contained herein without consulting first with his or her legal or other professional advisor with respect to the advisability of any specific course of action and the applicable law.

The views presented herein reflect the views of the individual author(s). They do not necessarily reflect the views of Bressler, Amery & Ross, P.C. or any of its other attorneys or clients.

17 State Street
New York, NY 10004
212.425.9300

325 Columbia Turnpike
Florham Park, NJ 07932
973.514.1200

200 East Las Olas Blvd.
Ft. Lauderdale, FL 33301
954.499.7979

www.bressler.com

©2012 Bressler, Amery & Ross, P.C.
All rights reserved.

ATTORNEY ADVERTISING