

FINRA Issues Additional Guidance on Suitability Rule

New Financial Industry Regulatory Authority, Inc. (“FINRA”) rules governing broker-dealer “know your customer” and suitability obligations (FINRA Rules 2090 and 2111) became effective July 9, 2012. FINRA recently issued additional guidance on the scope of the terms “customer” and “investment strategy”. FINRA also recently created a suitability website that aggregates questions and answers with respect to FINRA Rule 2111. This Client Alert summarizes the issues addressed in the latest guidance. The FINRA notice containing the new guidance is available [here](#).

For further discussion on the new suitability rules, please refer to the following publications:

- FINRA Issues Additional Guidance on New Suitability Rule (June 6, 2012) available [here](#).
- Doing Business Under FINRA’s New Suitability and KYC Rules (April 10, 2012) available [here](#).
- FINRA Announces New Know-Your-Customer and Suitability Compliance Date and Interpretive Guidance (May 19, 2011) available [here](#).
- SEC Approves FINRA Know-Your-Customer and Suitability Rules (January 18, 2011) available [here](#).

Suitability Rule

New FINRA Rule 2111 requires a FINRA member firm or associated person to 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 member or associated person to ascertain the customer’s investment profile. The rule emphasizes that the term “investment strategy involving a security or securities” is to be interpreted broadly. The rule is triggered when a firm or associated person recommends a security or strategy regardless of whether the recommendation results in a transaction. Among other things, the term “strategy” would capture a broker’s explicit

recommendation to *hold* a security or securities (i.e., where no transaction occurs).

Additional Guidance

In its earlier guidance, FINRA addressed numerous issues that members raised as they began assessing the new rule. As summarized below, FINRA recently provided additional guidance on the terms “customer” and “investment strategy” for purposes of the rule.

Customer

The suitability rule applies to a member firm’s or associated person’s recommendation of a security or investment strategy involving a security to a “customer”. FINRA has clarified its earlier guidance on what constitutes a “customer” for purpose of the suitability rule. FINRA’s definition of a customer (in FINRA Rule 0160) merely provides that “[t]he term ‘customer’ shall not include a broker or dealer.” For purposes of the suitability rule, the recent guidance clarifies that the term “customer” generally 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 compensation (directly or indirectly) even though the security is held at an issuer, the issuer’s affiliate or a custodial agent (e.g., “direct application” business, “investment program” securities, or private placements), or using another similar arrangement. The suitability rule would also apply when a firm or associated

person makes a recommendation to a potential investor who then becomes a customer.

Investment Strategy

FINRA has clarified its earlier guidance on what would be considered an “investment strategy” under the suitability rule. As noted above, the term “investment strategy” is to be interpreted broadly, but FINRA has stated that it 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 rule’s safe-harbor provision). Instead, the new guidance provides that the “investment strategy” language would apply to recommendations to customers to invest in more specific types of securities, such as high dividend companies, the “Dogs of the Dow,” or in a market sector (irrespective of whether the recommendations identify particular securities). The term would also apply to recommendations to customers generally to use a bond ladder, day trading, “liquefied home equity,” or a margin strategy involving securities (irrespective of whether the recommendations mention particular securities).

The new guidance also clarifies that the new suitability rule continues to cover a recommendation of an “investment strategy” involving both a security and a non-security investment, such as a recommendation to use home equity to purchase securities or to liquidate securities to purchase an investment-related product that is not a security. However, the suitability rule would not apply where any such recommendation does not refer to a security or securities (such as a customer deciding on her own to purchase a non-security investment and then asking a registered representative to recommend securities to sell to fund such purchase).

FINRA reminds broker-dealers that their supervisory responsibilities for a registered representative’s recommendation of an investment strategy involving both a security and a non-security investment must be reasonably designed in light of the particular facts and circumstances. FINRA provides little additional guidance other than noting that where a broker-dealer identifies a recommended investment strategy involving both a security and a non-security investment, its suitability obligations will apply to the security component and must be informed by a general understanding of the non-security component of the recommended investment strategy.

Suitability Website

FINRA has created a website repository for questions and answers relating to the suitability rules, including links to relevant Regulatory Notices and to the text of rules. This new website is available [here](#).

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at Chapman.com.

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