SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–62718; File No. SR–FINRA–2010–039]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change To Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook

August 13, 2010.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on July 30, 2010, Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items substantially have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability) as part of the Consolidated FINRA Rulebook. The proposed rules are based in large part on Incorporated NYSE Rule 405(1) (Diligence as to Accounts) and, NASD Rule 2310 (Recommendations to Customers (Suitability)) and its related Interpretative Materials ("IMs") respectively. As further detailed herein, the proposed rule change would delete those NASD and Incorporated NYSE rules and related NASD IMs and Incorporated NYSE Rule Interpretations.

The text of the proposed rule change is available on FINRA's Web site at *http://www.finra.org,* at the principal office of FINRA and at the Commission's Public Reference Room. In addition, the text of the proposed rule change is included as Exhibit 5 on the Commission's Web site at: *http://www.sec.gov/rules/sro/finra.shtml,* under the heading SR–FINRA–2010–039.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

As part of the process of developing a new consolidated rulebook ("Consolidated FINRA Rulebook"),[3] FINRA is proposing to adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). The rules are based in large part on NYSE Rule 405(1) (Diligence as to Accounts) and NASD Rule 2310 (Recommendations to Customers (Suitability)) and its related IMs, respectively.[4] As further discussed below, the proposed rule change would delete NASD Rule 2310, IM–2310–1 (Possible Application of SEC Rules 15g–1 through 15g–9), IM–2310–2 (Fair Dealing with Customers), IM–2310–3 (Suitability Obligations to Institutional Customers), NYSE Rule 405(1) through (3) (including NYSE Supplementary Material 405.10 through .30), and NYSE Rule Interpretations 405/01 through/04.[5]

The "know your customer" and suitability obligations are critical to ensuring investor protection and fair dealing with customers. Under the proposal, the core features of these obligations set forth in NYSE Rule 405(1) and NASD Rule 2310 remain intact. FINRA, however, proposes modifications to both rules to strengthen and clarify them. In *Regulatory Notice* 09–25 (May 2009), FINRA sought comment on the proposal. The current filing includes additional proposed changes that respond to comments.

Item II.C. of this filing provides a detailed discussion of the proposed modifications, comments FINRA received, and FINRA's responses thereto. In brief, however, the proposed FINRA "Know Your Customer" obligation, designated FINRA Rule 2090, captures the main ethical standard of NYSE Rule 405(1). As proposed, broker-dealers would be required to use "due diligence," in regard to the opening and maintenance of every account, in order to know the essential facts concerning every customer.[6] The obligation would arise at the beginning of the customer/broker relationship, independent of whether the broker has made a recommendation. The proposed supplementary material would define "essential facts" as those "required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[7]

The proposal would eliminate the requirement in NYSE Rule 405(1) to learn the essential facts relative to "every order." FINRA proposes eliminating the "every order" language because of the application of numerous, specific order-handling rules.[8] In addition, the reasonable-basis obligation under the suitability rule requires broker-dealers and associated persons to perform adequate due diligence so that they "know" the securities and strategies they recommend.

FINRA also is proposing to delete NYSE Rule 405(2) through (3), NYSE

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE ("Incorporated NYSE Rules") (together, the NASD Rules and Incorporated NYSE Rules are referred to as the "Transitional Rulebook"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE ("Dual Members"). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, *see Information Notice,* March 12, 2008 (Rulebook Consolidation Process).

[4] For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

[5] FINRA notes that NYSE Rule 405(4) was eliminated from the Transitional Rulebook on June 14, 2010 pursuant to a previous rule filing. *See* Securities Exchange Act Release No. 61808 (March 31, 2010), 75 FR 17456 (April 6, 2010) (Order Approving File No. SR–FINRA–2010–005); *see also Regulatory Notice* 10–21 (April 2010).

[6] *See* Proposed FINRA Rule 2090.

[7] *See* Proposed FINRA Rule 2090.01. As discussed *infra* at Item II.C. of this filing, FINRA changed the explanation of "essential facts" in response to comments.

[8] *See, e.g.,* SEC Regulation NMS (National Market System), 17 CFR 242.600–242.612; FINRA Rule 7400 Series (Order Audit Trail System); NASD Rule 2320 (Best Execution and Interpositioning) [proposed FINRA Rule 5310; *see Regulatory Notice* 08–80 (December 2008)]; NASD Rule 2400 Series (Commissions, Mark-Ups and Charges); NASD IM–2110–2 (Trading Ahead of Customer Limit Order) [proposed FINRA Rule 5320; *see* SR–FINRA–2009–090]; and IM–2110–3 (Front Running Policy) [proposed FINRA Rule 5270; *see Regulatory Notice* 08–83 (December 2008)].

Supplementary Material 405.10 through .30, and NYSE Rule Interpretation 405/01 through /04 because they generally are duplicative of other rules, regulations, or laws. For instance, NYSE Rule 405(2) requires firms to supervise all accounts handled by registered representatives. That provision is redundant because NASD Rule 3010 requires firms to supervise their registered representatives.[9]

NYSE Rule 405(3) generally requires persons designated by the member to be informed of the essential facts relative to the customer and to the nature of the proposed account and to then approve the opening of the account. A number of other existing and proposed FINRA rules do or will create substantially similar obligations. Proposed FINRA Rule 2090, discussed herein, would require members to know the essential facts as to each customer. NASD Rule 3110(c)(1)(C) requires the signature of the member, partner, officer or manager who accepts the account.[10]

A firm's account-opening obligations also are impacted by FINRA Rule 3310, which requires a firm to have procedures reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations. One of those regulations requires the firm to verify the identity of a customer opening a new account.[11] Another requires due diligence that would enable the firm to evaluate the risk of each customer and to determine if transactions by the customer could be suspicious and need to be reported.[12] Moreover, before certain customers can purchase certain types of investment products (such as options, futures or penny stocks) or engage in certain strategies (such as day trading), the firm must explicitly approve their accounts for such activity.[13]

NYSE Supplementary Material 405.10 is redundant of other FINRA proposed and existing requirements, and the cross references provided in .20 and .30 are no longer necessary. NYSE Supplementary Material 405.10 generally discusses the requirements that firms know their customers and understand the authority of third-parties to act on behalf of customers that are legal entities. Proposed FINRA Rule 2090 and proposed FINRA Supplementary Material 2090.01, discussed herein, would require firms to know the essential facts as to each customer. NYSE Supplementary Material 405.10 also discusses certain documentation obligations regarding persons authorized to act on behalf of various types of customers that are legal entities. NASD Rule 3110(c) (Customer Account Information), however, similarly requires firms to maintain a record identifying the person(s) authorized to transact business on behalf of a customer that is a legal entity.[14] NYSE Supplementary Material 405.20 and .30 provide cross references to NYSE Rule 382 (Carrying Agreements) and NYSE Rule 414 (Index and Currency Warrants), respectively, which are no longer necessary or appropriate for inclusion in proposed FINRA Rule 2090.

The NYSE Rule Interpretations also are redundant. NYSE Rule Interpretations 405/01 (Credit Reference—Business Background) and /02 (Approval of New Accounts/Branch Offices) recommend that the credit references and business backgrounds of a new account be cleared by a person other than the registered representative opening the account and require a designated person to ultimately approve a new account. These obligations are substantially similar to the requirements in NASD Rule 3110(c)(1)(C) and FINRA Rule 3310, discussed above.

NYSE Rule Interpretation 405/03 (Fictitious Orders) states that firm "personnel opening accounts and/or accepting orders for new or existing accounts should make every effort to verify the legitimacy of the account and the validity of every order." The interpretation contemplates knowing the customer behind the order as part of the process of ensuring that the order is bona fide. Proposed FINRA Rule 2090 and FINRA Rule 3310 together place similar requirements on firms to know their customers.

To the extent NYSE Rule Interpretation 405/03 seeks to guard against the use of fictitious trades as a means of manipulating markets, various FINRA rules cover such activities. FINRA Rule 5210 (Publication of Transactions and Quotations) prohibits members from publishing or circulating or causing to publish or circulate, any notice, circular, advertisement, newspaper article, investment service, or communication of any kind which purports to report any transaction as a purchase or sale of, or purports to quote the bid or asked price for, any security unless such member believes that such transaction or quotation was bona fide. FINRA Rule 5220 (Offers at Stated Prices) prohibits members from making an offer to buy from or sell to any person any security at a stated price unless such member is prepared to purchase or sell at such price and under such conditions as are stated at the time of such offer to buy or sell. Moreover, the use of fictitious transactions by a member or associated person to manipulate the market would violate FINRA's just and equitable principles of trade (FINRA Rule 2010) and anti-fraud provision (FINRA Rule 2020).[15]

NYSE Rule Interpretation 405/04 (Accounts in which Member Organizations have an Interest) discusses requirements regarding transactions initiated "on the Floor" for an account in which a member organization has an interest. The interpretation is directed to the NYSE marketplace. Moreover, Section 11(a) of the Act and the rules thereunder address trading by members of exchanges, brokers and dealers. For the reasons discussed above, FINRA believes NYSE Rule 405(1) through (3), NYSE Supplementary Material 405.10 through .30, and NYSE Rule Interpretations 405/01 through /04 are no longer necessary. They will be eliminated from the current FINRA rulebook upon Commission approval and implementation by FINRA of this current proposed rule change.

The proposed new suitability rule, designated FINRA Rule 2111, would require a broker-dealer 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 * * *."[16] This assessment must be "based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile, including, but not

[9] FINRA is proposing to adopt NASD Rule 3010 as FINRA Rule 3110, subject to certain amendments. *See Regulatory Notice* 08–24 (May 2008).

[10] FINRA is proposing to adopt NASD Rule 3110(c)(1)(C) as FINRA Rule 4512(a)(1)(C), subject to certain amendments. *See Regulatory Notice* 08–25 (May 2008). Proposed FINRA Rule 4512(a)(1)(C) would clarify that members maintain the signature of the partner, officer or manager denoting that the account has been accepted in accordance with the member's policies and procedures for acceptance of accounts.

[11] *See* 31 CFR 103.122.

[12] *See* 31 CFR 103.19.

[13] *See, e.g.,* SEA Rule 15g–1 through 15g–9 (Penny Stock Rules); FINRA Rule 2360 (Options); FINRA Rule 2370 (Security Futures); FINRA Rule 2130 (Approval Procedures for Day-Trading Accounts).

[14] As noted previously, FINRA is proposing to adopt NASD Rule 3110(c) as FINRA Rule 4512 (Customer Account Information), subject to certain amendments. *See Regulatory Notice* 08–25 (May 2008).

[15] *See, e.g., Terrance Yoshikawa,* Securities Exchange Act Release No. 53731, 2006 SEC LEXIS 948 (April 26, 2006) (upholding finding that president of broker-dealer violated just and equitable principles of trade and anti-fraud provisions by fraudulently entering orders designed to manipulate the price of securities).

[16] *See* Proposed FINRA Rule 2111(a).

limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."[17]

The proposal would add the term "strategy" to the rule text so that the rule explicitly covers a recommended strategy. Although FINRA generally intends the term "strategy" to be interpreted broadly, the proposed supplementary material would exclude the following communications from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities:

- General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimating future retirement income needs, and (v) assessment of a customer's investment profile;
- Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;
- Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with NASD IM–2210–6 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD IM–2210–6;[18] and
- Interactive investment materials that incorporate the above.[19]

The proposal also would codify interpretations of the three main suitability obligations, listed below:

- Reasonable basis (members must have a reasonable basis to believe, based on adequate due diligence, that a recommendation is suitable for at least *some* investors);
- Customer specific (members must have reasonable grounds to believe a recommendation is suitable for the particular investor at issue); and
- Quantitative (members must have a reasonable basis to believe the number of recommended transactions within a certain period is not excessive).[20]

In addition, the proposal would modify the institutional-customer exemption by focusing on whether there is a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies,[21] and is exercising independent judgment in evaluating recommendations.[22] The proposal, moreover, would require institutional customers to affirmatively indicate that they are exercising independent judgment.[23] The proposal also would harmonize the definition of institutional customer in the suitability rule with the more common definition of "institutional account" in NASD Rule 3110(c)(4).[24]

Finally, the suitability proposal would eliminate or modify a number of the IMs associated with the existing suitability rule because they are no longer necessary. Some of the discussions are not needed because of the changes to the scope of the suitability rule proposed herein (*e.g.,* the proposed rule text would capture "strategies" currently referenced in IM–2310–3).[25] Others are redundant because they identify conduct explicitly covered by other rules (*e.g.,* inappropriate sale of penny stocks referenced in IM–2310–1 is covered by the SEC's penny stock rules,[26] fraudulent conduct identified in IM–2310–2 is covered by the FINRA and SEC anti-fraud provisions[27]).

Still other IM discussions have been incorporated in some form into the proposed rule or its supplementary material. For example, the exemption in IM–2310–3 dealing with institutional customers is modified and moved to the text of proposed FINRA Rule 2111.[28] In addition, the explication of the three main suitability obligations, currently located in IM–2310–2 and IM–2310–3, are consolidated into a single discussion in the proposed rule's supplementary material.[29] Similarly, the proposed rule's supplementary material includes a modified form of the current requirement in IM–2310–2 that a member refrain from recommending purchases beyond a customer's capability.[30] The supplementary material also retains the discussion in IM–2310–2 and IM–2310–3 regarding the suitability rule's significance in promoting fair dealing with customers and ethical sales practices.[31]

The only type of misconduct identified in the IMs that is neither explicitly covered by other rules nor incorporated in some form into the proposed new suitability rule is unauthorized trading, currently discussed in IM–2310–2. However, it is well-settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010 (previously NASD Rule 2110).[32]

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[17] *See* Proposed FINRA Rule 2111(a). As discussed *infra* at Item II.C. of this filing, FINRA modified various aspects of the proposed information-gathering requirements in response to comments.

[18] FINRA is proposing to adopt NASD IM–2210–6 as FINRA Rule 2214, without material change. *See Regulatory Notice* 09–55 (September 2009).

[19] *See* Proposed FINRA Rule 2111.02. As discussed *infra* at Item II.C. of this filing, FINRA included this exception to the rule's coverage in response to comments.

[20] *See* Proposed FINRA Rule 2111.03.

[21] *See* Proposed FINRA Rule 2111(b). The requirement in Proposed FINRA Rule 2111(b) that the firm or associated person have a reasonable basis to believe that "the institutional customer is capable of evaluating investment risks independently, *both in general and with regard to particular transactions and investment strategies*" comes from current IM–2310–3. As FINRA explained in that IM, "[i]n some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk." FINRA further stated that, "[i]f a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer." FINRA also stated that "the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent decision."

[22] *See* Proposed FINRA Rule 2111(b).

[23] *See* Proposed FINRA Rule 2111(b). As discussed *infra* at Item II.C. of this filing, FINRA substituted this requirement for another in response to comments. FINRA emphasizes that the institutional-customer exemption applies only if both parts of the two-part test are met: (1) There is a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, in general and with regard to particular transactions and investment strategies, *and* (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating recommendations.

[24] *See* Proposed FINRA Rule 2111(b). FINRA is proposing to adopt NASD Rule 3110(c)(4) as FINRA Rule 4512(c), without material change. *See Regulatory Notice* 08–25 (May 2008).

[25] *See* Proposed Rule 2111(a).

[26] *See* SEA Rule 15g–1 through 15g–9.

[27] *See* Section 10(b) of the Act; FINRA Rule 2020.

[28] *See* Proposed Rule 2111(a).

[29] *See* Proposed Rule 2111.03.

[30] *See* Proposed Rule 2111.04.

[31] *See* Proposed Rule 2111.01.

[32] *See, e.g., Robert L. Gardner,* 52 S.E.C. 343, 344 n.1 (1995), *aff'd,* 89 F.3d 845 (9th Cir. 1996) (table

Consequently, the elimination of the discussion of unauthorized trading in the IMs following the suitability rule in no way alters the longstanding view that unauthorized trading is serious misconduct and clearly violates FINRA's rules.

FINRA will announce the implementation date of the proposed rule change in a *Regulatory Notice* to be published no later than 90 days following Commission approval. The implementation date will be no later than 240 days following Commission approval.

2. Statutory Basis

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[33] which requires, among other things, that FINRA's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change furthers these purposes because it requires firms and associated persons to know, deal fairly with, and make only suitable recommendations to customers.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

As noted above, the proposed rule change was published for comment in *Regulatory Notice* 09–25 (May 2009). A copy of the *Notice* can be viewed at *http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118709.pdf.* FINRA received 2,083 comment letters, 389 of which were individualized letters and 1,694 of which were form letters. An index to the comment letters received in response to the *Notice* can be viewed at *http://www.finra.org/Industry/Regulation/Notices/2009/P118711,* and copies of the comment letters received in response to the *Notice* can also be accessed through that Web site. In addition, these documents, submitted with FINRA's filing as Exhibits 2a, 2b, and 2c, respectively, can be viewed at the Commission's Web site at: *http://www.sec.gov/rules/sro/finra.shtml,* under the heading SR–FINRA–2010–039.

Comments came from broker-dealers, insurers, investment advisers, academics, industry associations, investor-protection groups, lawyers in private practice, and a state government agency. Commenters had myriad different views regarding nearly every aspect of the proposal. A discussion of those comments and FINRA's responses thereto follows.

KNOW YOUR CUSTOMER

(Proposed FINRA Rule 2090)

The proposal would require broker-dealers to use "due diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer." Although there were some comments generally in favor of the proposal,[34] most comments addressed specific language, as discussed below.

Essential Facts

The proposal states that broker-dealers must attempt to learn the "essential facts" concerning every customer. Supplementary Material .01 that was discussed in the *Notice* seeking comment clarified that "facts 'essential' to 'knowing the customer' included the customer's financial profile and investment objectives or policy." That language generated a fairly large number of comments.

• Comments

A number of commenters argued that the collection of financial profile and investment objective information under the proposed "know your customer" rule is a new requirement and unnecessarily confuses "know your customer" obligations with suitability obligations.[35] One commenter believed it would mislead customers into incorrectly thinking that a firm would only permit a customer to execute a self-directed transaction if it has determined that the transaction is appropriate for that customer.[36] Along those same lines, other commenters believed the requirement would be particularly problematic where a customer's trading activity is self-directed or directed by an independent investment adviser because regulators or private litigants could seek to hold firms accountable for permitting unsolicited customer trading activity that is inconsistent with the "know your customer" information that is on record at the firm.[37]

Some of these commenters supported "know your customer" obligations, but believed they should be limited in scope to essential facts necessary to open the account—*i.e.,* the identity and address of each account owner, the legal authorization of each person having investment authority with respect to the account, the source of funding for the account, and the credit status of the account owners.[38] Some commenters suggested removing proposed Supplementary Material .01 to Rule 2090 in its entirety and instead permitting each firm to interpret and apply the "essential facts" standard to their particular business model, recognizing that it is the nature of the relationship between the firm and customer that dictates those facts.[39] Another commenter similarly stated that the information should be limited to an investor's name, address, and tax identification number, which the commenter asserted was all the information that is needed to know the customer's identity and to make a credit determination.[40]

One commenter, however, believed that firms should have to make reasonable efforts to collect the types of information delineated in paragraph (a) of proposed Rule 2111.[41] This commenter indicated that each of those factors is essential to knowing the customer.[42] Others suggested that the term should be clarified.[43]

• FINRA's Response

format); *Keith L. DeSanto,* 52 S.E.C. 316, 317 n.1 (1995), *aff'd,* 101 F.3d 108 (2d Cir. 1996) (table format); *Jonathan G. Ornstein,* 51 S.E.C. 135, 137 (1992); *Dep't of Enforcement* v. *Griffith,* No. C01040025, 2006 NASD Discip. LEXIS 30, at *11–12 (NAC Dec. 29, 2006); *Dep't of Enforcement* v. *Puma,* No. C10000122, 2003 NASD Discip. LEXIS 22, at *12 n.6 (NAC Aug. 11, 2003).

[33] 15 U.S.C. 78*o*–3(b)(6).

[34] *See, e.g.,* Cornell Letter, *supra* note 44.

[35] *See* Charles Schwab Letter, *supra* note 47; Matthew Farley, Drinker, Biddle & Reath LLP, June 29, 2009 ("Drinker Biddle Letter"); FOLIOfn Letter, *supra* note 63; NAIBD Letter, *supra* note 63; NSCP Letter, *supra* note 35; SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63; T. Rowe Price Letter, *supra* note 44; Wells Fargo Letter, *supra* note 63.

[36] *See* T. Rowe Price Letter, *supra* note 44.

[37] *See* Charles Schwab Letter, *supra* note 47; Drinker Biddle Letter, *supra* note 132; FOLIOfn Letter, *supra* note 63; SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63; Wells Fargo Letter, *supra* note 63. One commenter made the same claim in the context of clearing firms and also stated that requiring a clearing firm to maintain this information as well as the introducing firm—which has the primary if not exclusive contact with the customer—would create a needless redundancy of effort, expense and information storage. *See* Drinker Biddle Letter, *supra* note 132.

[38] *See* SIFMA Letter, *supra* note 48; Wells Fargo Letter, *supra* note 63.

[39] *See* SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63; Wells Fargo Letter, *supra* note 63.

[40] *See* FOLIOfn Letter, *supra* note 63.

[41] *See* Cornell Letter, *supra* note 44.

[42] *See* Cornell Letter, *supra* note 44.

[43] *See* Committee of Annuity Insurers Letter, *supra* note 35.

After analyzing the comments, FINRA agrees with those commenters who stated that the "know your customer" obligation should remain flexible and that the extent of the obligation generally should depend on a particular firm's business model, its customers, and applicable regulations. As a result, FINRA has modified proposed Supplementary Material .01 to FINRA Rule 2090 so that it is less prescriptive. That provision now states: "For purposes of this Rule, facts 'essential' to 'knowing the customer' are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."

Maintenance of Every Account

A few commenters focused on the "maintenance" aspect of the "know your customer" requirement.

• Comments

Two commenters stated that the "maintenance" language was both new and vague and would lead to practical implementation issues, particularly in the retirement plan marketplace.[44] The commenters stated that FINRA should provide more guidance on what it means by "maintenance" and an opportunity to comment if it keeps the term.[45]

• FINRA's Response

FINRA believes that it is self-evident that a broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customer accounts. Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information. Firms should verify the essential facts about customers at intervals reasonably calculated to prevent and detect any mishandling of customer accounts that might result from changes to the "essential facts" about the customers.[46] The reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case.

Not Applicable to Every Order

At present, NYSE Rule 405(1) applies to "every order." The proposal eliminates this language.

• Comments

Two commenters argued that the proposed "know your customer" rule should, as is true currently under NYSE Rule 405(1), require due diligence as to "every order" and not simply as to every account.[47] These commenters stated that it was a mistake to focus on knowing the customer rather than knowing both the customer and the product.[48] One of these commenters did not believe that reasonable-basis suitability provides enough protection in that respect in part because the suitability rule applies only when a recommendation is made.[49]

• FINRA's Response

FINRA is not proposing to adopt the NYSE requirement to learn the essential facts relative to every order in NYSE Rule 405(1), given the application of specific order-handling rules.[50] In addition, as noted by a commenter, the reasonable-basis obligation under the suitability rule requires broker-dealers and associated persons to know the securities and strategies they recommend through performing adequate due diligence.

SUITABILITY

(Proposed FINRA Rule 2111)

Fiduciary Standard

Although FINRA did not request comment on whether fiduciary obligations should influence the suitability proposal, more than a thousand commenters raised issues involving fiduciary obligations. A brief discussion of these issues is thus warranted.

• Comments

One commenter suggested that FINRA should consider a fiduciary duty standard in addition to a suitability standard.[51] Numerous other commenters argued that FINRA should not move forward with proposed changes to the suitability rule until after policymakers (*e.g.,* Congress, the SEC, and/or FINRA) determine whether broker-dealers must comply with fiduciary obligations.[52] One commenter further posited that it would be easier for firms to implement a single, integrated change to customer care standards adopted at one time.[53]

• FINRA's Response

FINRA notes that the application of a suitability standard is not inconsistent with a fiduciary duty standard. In this regard, the SEC emphasized in one release that "investment advisers under the Advisers Act," who have fiduciary duties, "owe their clients the duty to provide only suitable investment advice * * *. To fulfill this suitability obligation, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives."[54] In another release, the SEC similarly explained that "[i]nvestment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice."[55]

Suitability obligations constitute a material part of a fiduciary standard in the context of investment advice and recommendations. It also is important to note that case law makes clear that, under FINRA's suitability rule, "a broker's recommendations must be consistent with his customers' best interests."[56] Thus, the suitability obligations set forth in proposed Rule 2111 would not be inconsistent with the

[44] *See* Committee of Annuity Insurers Letter, *supra* note 35; Hancock, MetLife and Prudential Letter, *supra* note 51.

[45] *See* Committee of Annuity Insurers Letter, *supra* note 35; Hancock, MetLife and Prudential Letter, *supra* note 51.

[46] Broker-Dealers should note, however, that, under SEA Rule 17a–3, they must, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations.

[47] *See* Cornell Letter, *supra* note 44; NASAA, *supra* note 34.

[48] *See* Cornell Letter, *supra* note 44; NASAA, *supra* note 34.

[49] *See* NASAA, *supra* note 34.

[50] *See supra* note 25.

[51] Rex A. Staples, General Counsel for the North American Securities Administrators Association, July 13, 2009 ("NASAA Letter").

[52] *See* Joan Hinchman, Executive Director, President, and CEO of the National Society of Compliance Professionals Inc., June 29, 2009 ("NSCP Letter"); Clifford Kirsch and Eric Arnold, Sutherland Asbill & Brennan LLP for the Committee of Annuity Insurers, June 29, 2009 ("Committee of Annuity Insurers Letter"). In addition, 435 individuals and entities made this point, among others, using one form letter ("Form Letter Type A") and 1,197 individuals did so using another form letter ("Form Letter Type B").

[53] *See* NSCP Letter, *supra* note 35.

[54] Release Nos. IC–22579, IA–1623, S7–24–95, 1997 SEC LEXIS 673, at *26 (Mar. 24, 1997) (Status of Investment Advisory Programs under the Investment Company Act of 1940). *See also Shearson, Hammill & Co.,* 42 S.E.C. 811 (1965) (finding willful violations of Section 206 of the Advisers Act when investment adviser made unsuitable recommendations).

[55] Investment Advisers Act Release No. 1406, 1994 SEC LEXIS 797, at *4 (Mar. 16, 1994) (Suitability of Investment Advice Provided by Investment Advisers).

[56] *Raghavan Sathianathan,* Securities Exchange Act Release No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006), *aff'd,* 304 F. App'x 883 (D.C. Cir. 2008); *see also Dane S. Faber,* Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23–24 (Feb. 10, 2004) (explaining that a broker's recommendations "must be consistent with his customer's best interests"); *Daniel R. Howard,* 55 S.E.C. 1096, 1099–1100 (2002) (same), *aff'd,* 77 F. App'x 2 (1st Cir. 2003).

addition of a fiduciary duty at some future date.[57]

Scope of the Suitability Rule

FINRA sought comment on two main issues potentially impacting the scope of the suitability rule: whether to add the term "strategy" to the rule language and whether to broaden the rule so that it reaches non-securities products. The second issue was not highlighted in the rule text. Rather, it was raised in a discussion in the *Notice* seeking comment.

Scope of the Suitability Rule/Strategies

The issue of whether the suitability rule applies to recommended strategies has been addressed previously. SEC and FINRA discussions in IMs, releases, and notices, as well as in some decisions, indicate that the current suitability rule applies to certain types of recommended strategies.

NASD IM–2310–3 (Suitability Obligations to Institutional Customers) provides in its "Preliminary Statement" that broker-dealers' "responsibilities include having a reasonable basis for recommending a particular security *or strategy,* as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made." Similarly, *Notices to Members* have stated that broker-dealers' responsibilities under Rule 2310 "include having a reasonable basis for recommending a particular security *or strategy.*"[58] Moreover, when the SEC published FINRA's Online Suitability Policy Statement, *Notice to Members* 01–23 (Apr. 2001) ("*NTM 01–23*"), in the **Federal Register**, the Commission included the following statement in the release: "The Commission notes that although [*NTM*] *01–23* does not expressly discuss electronic communications that recommend investment strategies, the NASD suitability rule continues to apply to the recommendation of investment strategies, whether that recommendation is made via electronic communication or otherwise."[59]

A number of SEC decisions also support application of the suitability rule to recommended strategies. The case often cited as standing for such a proposition is *F.J. Kaufman & Co.,* 50 S.E.C. 164 (1989), in which the SEC found that the respondent violated NASD Rule 2310 by recommending an unsuitable strategy to customers. A number of Commission decisions issued after *Kaufman* also lend support for applying the suitability rule to recommended strategies in certain situations. Many of these cases involved recommendations to purchase securities on margin (which can be viewed as a strategy).[60]

The proposed suitability rule explicitly covers recommended strategies. The commenters' views on the inclusion of the term were varied.

• Comments

A number of commenters supported the addition of the term to the rule text.[61] Some commenters requested that FINRA make clear in the supplementary material that the term "strategy" should be interpreted broadly and include recommendations to hold an investment.[62] Some of these commenters also believed that firms should have an affirmative duty to review portfolios that are transferred into a firm and that the lack of a recommendation to make any changes to the portfolio effectively constitutes an implicit recommendation to retain what is in the account.[63]

Other commenters supported the inclusion of the term strategy but asked FINRA to clarify that the suitability rule would apply only to recommended "strategies *resulting* in the purchase, sale or exchange of a security or securities"[64] or where there is a "reasonable nexus between the recommended investment strategy and a securities transaction in furtherance of the recommended strategy."[65] Other commenters stated that FINRA should define or clarify the term "strategy."[66] One of these commenters believed that, without a definition, there would be confusion among firms and FINRA examiners regarding whether all asset allocation programs and "buy and hold" recommendations should be viewed as strategies.[67]

A number of commenters opposed the inclusion of the term "strategy."[68] However, one of these commenters stated that, if FINRA includes the term in the final proposal, FINRA should except from the rule's coverage any information determined to be "investment education" under the Employee Retirement Income Security Act ("ERISA").[69]

• FINRA's Response

FINRA agrees that the term "strategy" should be included in the rule language and that, in general, it should be interpreted broadly. For instance, FINRA rejects the contention that the rule should only cover a recommended

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[57] FINRA notes as well that the suitability rule is only one of many FINRA business-conduct rules with which broker-dealers and their associated persons must comply. Many FINRA rules prohibit, limit, or require disclosure of conflicts of interest. Broker-dealers and their associated persons, for instance, must comply with just and equitable principles of trade, standards for communications with the public, order-handling requirements, fair-pricing standards, and various disclosure obligations regarding research, trading, compensation, margin, and certain sales and distribution activity, among others, in addition to suitability obligations.

[58] *See Notice to Members* 96–32, 1996 NASD LEXIS 51, at *2 (May 1996); *see also Notice to Members* 05–68, 2005 NASD LEXIS 44, at *11 (Oct. 2005) (stating that members and their associated persons "should perform a careful analysis to determine whether liquefying home equity [to facilitate the purchase of securities] is a suitable strategy for an investor"); *Notice to Members* 04–89, 2004 NASD LEXIS 76, at *7 (Dec. 2004) (same). (*Change to footnote made per e-mail from James Wrona, Associate Vice President and Associate General Counsel, FINRA, to Bonnie Gauch, Special Counsel, Division of Trading and Markets, Commission, dated August 12, 2010.*)

[59] *See* Securities Exchange Act Release No. 44178, 2001 SEC LEXIS 731, at *28–29 (April 12, 2001), 66 FR 20697, 20702 (April 24, 2001) (Notice of Filing and Immediate Effectiveness of FINRA's Online Suitability Policy Statement).

[60] *See, e.g., Jack H. Stein,* Securities Exchange Act Release No. 47335, 2003 SEC LEXIS 338, at *15 (Feb. 10, 2003); *Justine S. Fischer,* 53 S.E.C. 734 (1998); *Stephen T. Rangen,* 52 S.E.C. 1304, 1307–1308 (1997); *Arthur J. Lewis,* 50 S.E.C. 747, 748–50 (1991).

[61] *See* Barbara Black, Director of the Corporate Law Center of the University of Cincinnati College of Law, and Jill I. Gross, Director of the Investor Rights Clinic of the Pace University School of Law ("Corporate Law Center & Investor Rights Clinic"), June 29, 2009; Peter J. Harrington, Christine Lazaro & Lisa A. Catalano, Securities Arbitration Clinic at St. John's University, June 25, 2009 ("St. John's Letter"); William A. Jacobson and Sang Joon Kim, Cornell Securities Law Clinic, June 27, 2009 ("Cornell Letter"); Sarah McCafferty, Vice President and Chief compliance Officer at T.RowePrice, June 29, 2009 ("T.RowePrice Letter"); Peter J. Mougey and Kristian P. Kraszewski, Levin, Papantonio, Thomas, Mitchell, Echsner & Proctor P.A., June 29, 2009 ("Mougey and Kraszewski Letter"); Daniel C. Rome, General Counsel of Taurus Compliance Consulting LLC, June 29, 2009 ("Taurus Letter").

[62] *See* Cornell Letter, *supra* note 44; Mougey and Kraszewski Letter, *supra* note 44; St. John's Letter, *supra* note 44.

[63] *See* Mougey and Kraszewski Letter, *supra* note 43; St. John's Letter, *supra* note 44.

[64] *See* Bari Havlik, SVP and Chief Compliance Officer for Charles Schwab & Co., June 29, 2009 ("Charles Schwab Letter").

[65] *See* Amal Aly, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, June 29, 2000 ("SIFMA Letter"); NSCP Letter, *supra* note 35.

[66] *See* NSCP Letter, *supra* note 35. A number of commenters stated that FINRA should eliminate the term strategy from the rule but argued that, if FINRA continues to use it, FINRA needed to clarify what the term means. *See* Committee of Annuity Insurers Letter, *supra* note 35; James Livingston, President and CEO of National Planning Holdings, Inc., June 29, 2009 ("National Planning Holdings"); Stephanie L. Brown, Managing Director and General Counsel for LPL Financial Corporation, June 29, 2009 ("LPL Letter").

[67] *See* NSCP Letter, *supra* note 35.

[68] *See* LPL Letter, *supra* note 48; Committee of Annuity Insurers Letter, *supra* note 34; Clifford E. Kirsch, Sutherland Asbill & Brennan LLP on behalf of John Hancock Life Insurance Co., MetLife Inc., and the Prudential Insurance Co. of America, June 29, 2009 ("Hancock, MetLife and Prudential Letter"); National Planning Holdings, *supra* note 49.

[69] *See* Hancock, MetLife and Prudential Letter, *supra* note 51 (citing 29 CFR 2509.96–1(d)).

strategy if it results in a transaction. As with the current suitability rule, application of the proposed rule would be triggered when the broker-dealer or associated person recommends the security or strategy regardless of whether the recommendation results in a transaction.[70] The term "strategy," moreover, would cover *explicit* recommendations to hold a security or securities. The rule recognizes that customers may rely on members' and associated persons' investment expertise and knowledge, and it is thus appropriate to hold members and associated persons responsible for the recommendations that they make to customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation.

In regard to the comment concerning *implicit* recommendations on portfolios transferred to a firm, FINRA notes that nothing in the current rule proposal is intended to change the longstanding application of the suitability rule on a recommendation-by-recommendation basis. In limited circumstances, FINRA and the SEC have recognized that implicit recommendations can trigger suitability obligations. For example, FINRA and the SEC have held that associated persons who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule.[71] The rule proposal is not intended to broaden the scope of *implicit* recommendations.

As discussed in Item 3 of this rule filing, FINRA also proposes to explicitly exempt from the rule's coverage certain categories of educational material as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities. FINRA believes that it is important to encourage broker-dealers and associated persons to freely provide educational material and services to customers. As one commenter explained, the U.S. Department of Labor provided a similar exemption from some requirements under ERISA.[72]

Scope of the Suitability Rule/Non-Securities Products

The current suitability rule and the proposed new suitability rule cover recommendations involving securities. In the *Notice* seeking comment, however, FINRA asked whether the suitability rule should cover recommendations of non-securities products made in connection with the firm's business. This issue generated the greatest number of comments, most of which were against extending the rule's reach.

• Comments

Some commenters favored broadening the suitability rule so that it covers non-securities products.[73] One commenter stated that the expansion was needed because broker-dealers market more than just securities and oftentimes customers do not understand that they may be afforded less protection when purchasing non-securities products.[74] Another commenter stated that it would be unreasonable for a firm to allow a non-securities recommendation that was inconsistent with a customer's suitability profile.[75] Yet another commenter believed that broker-dealers implicitly already have similar obligations but favored explicitly applying the suitability rule to non-securities products.[76] According to this commenter, broker-dealers 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.[77] This commenter argued that the proposal was not an expansion of broker-dealer obligations; rather the proposal would make explicit what FINRA's rules have consistently required from broker-dealers and associated persons.[78] The commenter supported a revision of proposed Rule 2111 to incorporate an explicit suitability obligation that is not limited to securities.[79]

The vast majority of commenters, however, were against applying the suitability rule to non-securities products.[80] Some argued that FINRA did not have jurisdiction over non-securities products.[81] Some argued against the expansion because they claimed there is no evidence of abuse resulting from recommendations involving non-securities products.[82] Some commenters stated that such action is unnecessary because the states and federal regulators, and in some instances other self-regulatory organizations, already regulate many non-securities products and services (*e.g.,* insurance, real estate, investment advisers, futures products, etc.).[83] Others claimed that FINRA was ill-suited to regulate non-securities products because it has no expertise

[70] *See, e.g., Dist. Bus. Conduct Comm.* v. *Nickles,* Complaint No. C8A910051, 1992 NASD Discip. LEXIS 28, at *18 (NBCC Oct. 19, 1992) (holding that suitability rule "applies not only to transactions that registered persons effect for their clients, but also to any recommendations that a registered person makes to his or her client").

[71] *See, e.g., Rafael Pinchas,* 54 S.E.C. 331, 341 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules."); *Paul C. Kettler,* 51 S.E.C. 30, 32 n.11 (1992) (stating that transactions broker effects for a discretionary account are implicitly recommended).

[72] *See* Hancock, MetLife and Prudential Letter, *supra* note 51 (citing 29 CFR 2509.96–1(d)).

[73] *See* Mougey and Kraszewski Letter, *supra* note 44; Taurus Letter, *supra* note 44.

[74] *See* Mougey and Kraszewski Letter, *supra* note 44.

[75] *See* Taurus Letter, *supra* note 44.

[76] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44.

[77] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44.

[78] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44.

[79] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44.

[80] *See, e.g.,* Michael Berenson, Morgan, Lewis & Bockius LLP on behalf of American Equity Life Insurance Company, June 23, 2009 ("AELIC Letter"); Charles Schwab Letter, *supra* note 47; Committee of Annuity Insurers Letter, *supra* note 35; John M. Damgard, President of the Futures Industry Association, June 29, 2009 ("FIA Letter"); Form Letter Type A, *supra* note 35; Form Letter Type B, *supra* note 35; Hancock, MetLife and Prudential Letter, *supra* note 51; James L. Harding, James L. Harding & Associates, Inc., July 1, 2009 ("Harding Letter"); Mike Hogan, President and CEO of FOLIOfn Investments, Inc., June 29, 2009 ("FOLIOfn Letter"); Ronald C. Long, Director of Regulatory Affairs for Wells Fargo Advisors, LLC, June 29, 2009 ("Wells Fargo Letter"); LPL Letter, *supra* note 51; John S. Markle, Deputy General Counsel for TD Ameritrade, June 29, 2009 ("TD Ameritrade Letter"); NSCP Letter, *supra* note 35; Lisa Roth, National Ass'n of Independent Broker-Dealers, Inc., June 29, 2009 ("NAIBD Letter"); Thomas W. Sexton, Senior Vice President & General Counsel for the National Futures Association, June 29, 2009 ("NFA Letter"), SIFMA Letter, *supra* note 48; T.RowePrice Letter, *supra* note 44; Robert R Carter and David A Stertzer, Association for Advanced Life Underwriting, June 29, 2009 ("AALU Letter"); Alan J Cyr, Cyr & Cyr Insurance Services, June 26, 2009 ("Cyr & Cyr Insurance Services Letter"); F. John Millette, IMG Financial Group, June 23, 2009 ("IMG Financial Group Letter"); Neal Nakagiri, NPB Financial Group, LLC, June 2, 2009 ("NPB Financial Group Letter"); Richard C. Orvis, Principal Life Insurance Co., June 23, 2009 ("Principal Life Insurance Co. Letter").

[81] *See, e.g.,* Committee of Annuity Insurers Letter, *supra* note 35; FOLIOfn Letter, *supra* note 63; Form Letter Type A, *supra* note 35; Form Letter Type B, *supra* note 35; Hancock, MetLife and Prudential Letter, *supra* note 51; LPL Letter, *supra* note 49; NSCP Letter, *supra* note 35; T.RowePrice Letter, *supra* note 44.

[82] *See, e.g.,* AALU Letter, *supra* note 63; AELIC Letter, *supra* note 63; Cyr & Cyr Insurance Services Letter, *supra* note 60; Principal Life Insurance Co. Letter, *supra* note 60.

[83] *See, e.g.,* AELIC Letter, supra note 63; Committee of Annuity Insurers Letter, *supra* note 35; FIA Letter, *supra* note 63; Form Letter Type A, *supra* note 35; Form Letter Type B, *supra* note 35; Hancock, MetLife and Prudential Letter, *supra* note 51; Michael T. McRaith, Illinois Department of Insurance Letter, June 29, 2009; NAIBD Letter, *supra* note 63; NFA Letter, *supra* note 63; NSCP Letter, *supra* note 35; SIFMA Letter, *supra* note 48.

outside securities issues.[84] A few argued that adoption of an enhanced suitability rule would create confusion regarding whether a recommendation is made "in connection with a firm's business."[85]

• FINRA's Response

With the possible exception of potentially duplicative regulation, which FINRA believes could be addressed in any further expansion of the reach of the rule, FINRA does not agree with the commenters' reasoning against extending the scope of the suitability rule. FINRA acknowledges, however, 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.

Scope of the Suitability Rule/ Clarification of the Term "Recommendation"

Consistent with the current suitability rule, the proposed new rule does not define the term "recommendation." FINRA received a number of comments regarding the term.

• Comments

Some commenters asked FINRA to define the term "recommendation."[86] One commenter believed that FINRA's failure to define "recommended transaction" will make it difficult for firms to distinguish recommended transactions from "discussed" and/or "reviewed" transactions.[87] This commenter stated that the "current compliance rule of thumb matches customer action within a measured period of time after information is provided to a customer as a test of whether any resulting transaction was 'recommended.' "[88] The commenter believes that "the discussion in *NTM 01–23* provides a good foundation upon which FINRA can base the definition."[89] Another commenter asked that FINRA reaffirm the principles discussed in *NTM 01–23* regarding the term "recommendation."[90] Other commenters argued that the term should be defined to include recommendations to hold securities.[91]

• FINRA's Response

The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case and, therefore, the fact of such action having taken place is not susceptible to a bright line definition.[92] As two commenters noted, however, FINRA announced several guiding principles in *NTM 01–23* regarding whether a communication constitutes a recommendation. In general, those guiding principles remain relevant.

For instance, FINRA stated that a communication's content, context, and presentation are important aspects of the inquiry. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or strategy, the more likely the communication will be viewed as a recommendation. FINRA also explained that a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. FINRA stated, moreover, that it makes no difference whether the communication was initiated by a person or a computer software program. Finally, FINRA noted the relevance of determining whether a reasonable person would view the communication as a recommendation. Thus, for example, FINRA explained that a broker could not avoid suitability obligations through a disclaimer where—given its content, context, and presentation—the particular communication reasonably would be viewed as a recommendation.[93]

These guiding principles, together with numerous litigated decisions and the facts and circumstances of any particular case, inform the determination of whether the communication is a recommendation for purposes of FINRA's suitability rule.[94] FINRA believes that this guidance and these precedents allow broker-dealers to fundamentally understand what communications likely do or do not constitute recommendations.

It also is important to emphasize that both the current and proposed suitability rules require that a recommendation be suitable when made. Firms may have different methods of tracking recommendations for a variety of reasons, but the main suitability obligation is not dependent on whether and, if so, where and how, a transaction occurs.[95]

Finally, as noted above, the proposed rule would capture explicit recommendations to hold securities as a result of FINRA's elimination of the "purchase, sale or exchange" language and the addition of the term "strategy." Accordingly, there is no reason to define "recommendation" to include recommendations to hold securities.

Information Gathering

The proposal discussed in the *Notice* seeking comment made two changes to the type of information that firms and associated persons had to attempt to gather and analyze as part of their suitability obligation. First, the proposal would have required the firm and associated person to consider information known by the firm or associated person. Second, the proposal included an expanded list of information that members and associated persons would have to

[84] *See, e.g.,* AALU Letter, *supra* note 63; Committee of Annuity Insurers Letter, *supra* note 35; Wells Fargo Letter, *supra* note 63.

[85] *See, e.g.,* AELIC Letter, *supra* note 63.

[86] *See* Barry D. Estell, Attorney at Law, June 24, 2009 ("Estell Letter"); FOLIOfn Letter, *supra* note 63; Mougey and Kraszewski Letter, *supra* note 44.

[87] *See* FOLIOfn Letter, *supra* note 63.

[88] *See* FOLIOfn Letter, *supra* note 63.

[89] *See* FOLIOfn Letter, *supra* note 63.

[90] TD Ameritrade Letter, *supra* note 63.

[91] *See* Estell Letter, *supra* note 69; Mougey and Kraszewski Letter, *supra* note 44.

[92] FINRA has stated that "defining the term 'recommendation' is unnecessary and would raise many complex issues in the absence of specific facts of a particular case." Securities Exchange Act Release No. 37588, 1996 SEC LEXIS 2285, at *29 (Aug. 20, 1996), 61 FR. 44100, 44107 (Aug. 27, 1996) (Notice of Filing and Order Granting Accelerated Approval of NASD's Interpretation of its Suitability Rule).

[93] In the same vein, it is important to note that a customer's acquiescence or desire to engage in a transaction does not relieve a broker-dealer or associated person of the responsibility to make only suitable recommendations. *See, e.g., Clinton H. Holland, Jr.,* 52 S.E.C. 562, 566 (1995) ("Even if we conclude that Bradley understood Holland's recommendations and decided to follow them, that does not relieve Holland of his obligation to make reasonable recommendations."), *aff'd,* 105 F.3d 665 (9th Cir. 1997) (table format); *John M. Reynolds,* 50 S.E.C. 805, 809 (1991) (regardless of whether customer wanted to engage in aggressive and speculative trading, representative was obligated to abstain from making recommendations that were inconsistent with the customer's financial condition); *Eugene J. Erdos,* 47 S.E.C. 985, 989 (1983) ("[W]hether [the customer] considered the transactions * * * suitable is not the test for determining the propriety of [the registered representative's] conduct."), *aff'd,* 742 F.2d 507 (9th Cir. 1984); *Dep't of Enforcement* v. *Bendetsen,* No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) ("[A] broker's recommendations must serve his client's best interests and that the test for whether a broker's recommendation is suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs.").

[94] To the extent that past *Notices to Members, Regulatory Notices,* case law, etc., do not conflict with proposed new rule requirements or interpretations thereof, they remain potentially applicable, depending on the facts and circumstances of the particular case.

[95] *See Nickles,* 1992 NASD Discip. LEXIS 28, at *18.

attempt to gather and analyze when making recommendations.

Information Gathering/Information Known by the Firm

The proposal discussed in the *Notice* would have required members and associated persons to consider all information about the customer that was "known by the member or associated person."

• Comments

Some commenters supported requiring firms and brokers to analyze information known by the firm regardless of how the firm learned of the information.[96] However, other commenters were opposed to this requirement.[97] Some were opposed because of the difficulty they believed it would cause for firms with multiple business lines.[98] According to these commenters, customers may provide information for a variety of different purposes (*e.g.,* banking, insurance, or securities transactions) to different employees working in different departments and recording the information on separate systems, and a single broker may not have access to all of that information.[99]

Other commenters opposed the language on the basis that it might require associated persons to capture and consider personal information that may not be relevant to investment decisions and that clients may not want captured in a system or shared with a broader audience (especially when the associated person has intimate knowledge of a client through a family relationship or friendship).[100] According to the commenters, examples may include a diagnosed illness, pending divorce or separation, pending legal action, or other personal problems.[101] Finally, some commenters believed that such a requirement could be unfair to associated persons in situations where firms are aware of information about customers but do not pass it along to the associated persons.[102]

• FINRA's Response

FINRA has modified the proposal and no longer refers to facts "known by the member or associated person." The current proposal requires the member or associated person to have reasonable grounds to believe the recommendation is suitable based on "information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile, including, but not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

"Reasonable diligence" is that level of effort that, based on the facts and circumstances of the particular case, provides the member or associated person with sufficient information about the customer to have reasonable grounds to believe that the recommended security or strategy is suitable. The level of importance of each category of customer information may vary depending on the facts and circumstances of the particular case. However, members and associated persons must use reasonable diligence to gather and analyze the customer information and may only make a recommendation if they have reasonable grounds to believe the recommendation is suitable. In this regard, failing to use reasonable diligence to gather the information or basing a recommendation on inadequate information would violate customer-specific suitability, which requires a broker-dealer to have a reasonable basis to believe a recommendation is suitable for the particular investor at issue.

Apart from the new "reasonable diligence" language, the modified proposal also alters the wording at the end of paragraph (a) of the proposed rule. Instead of requiring members and associated persons to consider "any other information the member or associated person considers to be reasonable," the modified proposal requires them to consider "any other information the customer may disclose to the member or associated person in connection with" the recommendation. In light of some of the comments noted above, FINRA believes it is important to tie this customer information to possible investment decisions.

Information Gathering/Additional Information

The proposal expands the explicit list of types of information that broker-dealers and associated persons have to attempt to gather and analyze. At present, the suitability rule requires that broker-dealers and associated persons attempt to gather information about and analyze the customer's other security holdings, financial situation and needs, financial status, tax status, investment objectives, and such other information used or considered to be reasonable by such member or associated person in making recommendations to the customer. FINRA expanded that list to include the customer's age, investment experience, investment time horizon, liquidity needs, and risk tolerance.

• Comments

Some commenters applauded FINRA for placing a clear affirmative duty on firms to make reasonable efforts to gather a more comprehensive and specific list of facts about the customer prior to making a recommendation.[103] These commenters believed that the investing public will benefit because broker-dealers will consider a larger number of consistent criteria.[104]

A few other commenters, while agreeing that such information is relevant in some situations, stated that obtaining each specified category of information may not be warranted on every occasion.[105] These commenters requested that FINRA build flexibility into the rule and not mandate that the member seek to obtain these new categories of information for every recommended transaction.[106] According to these commenters, broker-dealers should have discretion to determine what customer information is relevant to the suitability determination associated with each recommended transaction.[107] If FINRA does require firms to obtain and capture this information, these commenters also asked FINRA to establish an effective date for the new rule that recognizes the

[96] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44; St. John's Letter, *supra* note 44; Taurus Letter, *supra* note 44.

[97] *See* Charles Schwab Letter, *supra* note 47; Committee of Annuity Insurers Letter, *supra* note 35; FOLIOfn Letter, *supra* note 63; LPL Letter, *supra* note 49; NSCP Letter, *supra* note 35; SIFMA Letter, *supra* note 47; TD Ameritrade Letter, *supra* note 63.

[98] *See* Charles Schwab Letter, *supra* note 47; FOLIOfn Letter, *supra* note 63; NSCP Letter, *supra* note 35; SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63.

[99] *See* Charles Schwab Letter, *supra* note 47; SIFMA Letter, *supra* note 48.

[100] *See* Committee of Annuity Insurers Letter, *supra* note 35; National Planning Holdings, *supra* note 49.

[101] *See* Committee of Annuity Insurers Letter, *supra* note 35; National Planning Holdings, *supra* note 49.

[102] *See* LPL Letter, *supra* note 49; SIFMA Letter, *supra* note 48.

[103] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44; Mougey and Kraszewski Letter, *supra* note 44; St. John's Letter, *supra* note 44; T.RowePrice Letter, *supra* note 44.

[104] *See* St. John's Letter, *supra* note 44; Mougey and Kraszewski Letter, *supra* note 44.

[105] *See* Charles Schwab Letter, *supra* note 47; SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63; Wells Fargo Letter, *supra* note 63.

[106] *See* Charles Schwab Letter, *supra* note 47; SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63; Wells Fargo Letter, *supra* note 63.

[107] *See* Charles Schwab Letter, *supra* note 47; SIFMA Letter, *supra* note 48; TD Ameritrade Letter, *supra* note 63; Wells Fargo Letter, *supra* note 63.

difficulty associated with developing, modifying, and implementing forms and systems to request and capture the proposed new categories of information.[108]

Other commenters more strongly objected to the proposed expansion of the list of items that broker-dealers must attempt to gather and analyze.[109] One commenter argued that factors such as a customer's investment experience, time horizon, and risk tolerance are ones to be considered when reviewing a customer's portfolio as a whole, not individual trades.[110] According to this commenter, requiring consideration of such factors on a trade-by-trade basis will prevent customers from creating a diverse portfolio made up of securities with different levels of liquidity, risk, and time horizons.[111] This commenter also stated that requiring firms to attempt to gather information about a customer's "other investments" would be difficult because it would require an associated person to have a complete view of a customer's entire portfolio.[112] Another commenter went further and stated that the current list of items in Rule 2310 should be abolished.[113] The commenter stated that "FINRA should adopt a rule that states that broker dealers should collect sufficient data and perform the analysis that it, in its professional judgment, deems reasonably necessary to provide the services it offers and advertises to consumers."[114] If that cannot be achieved, the commenter recommends limiting the information to that discussed in SEA Rule 17a–3.[115] This commenter also argued that FINRA should detail exactly how firms are required to use each piece of information that FINRA requires firms to gather.[116]

Another commenter stated that FINRA should maintain a standard approach to the terminology used in relation to this aspect of the rule.[117] As an example, the commenter noted that the rule proposal uses the term "other investments," while FINRA Rule 2330 covering deferred variable annuities uses "existing assets (including investment and life insurance holdings)."[118] The commenter believed that "other investments" is overly broad and that FINRA should use the term currently used in Rule 2330.[119]

Finally, one commenter argued that money market mutual funds be exempted from all or some of the requirements to gather information when making recommendations.[120] According to the commenter, a current exemption from some information gathering for transactions in money market mutual funds should continue or be expanded in the proposed rule.[121]

• FINRA's Response

Under the current suitability rule, broker-dealers must attempt to gather information on and analyze the customer's other holdings, financial situation and needs, financial status, tax status, investment objectives, and such other information used or considered to be reasonable by the firm or associated person in making recommendations to the customer. The expanded information in the proposed rule includes the customer's age, investment experience, investment time horizon, liquidity needs, and risk tolerance. FINRA cannot dictate exactly how firms should use each piece of information. As discussed above, the level of importance of each category of customer information (not only those in the expanded list) may vary depending on the facts and circumstances of the particular case. However, failing to use reasonable diligence to gather the information or basing a recommendation on inadequate information would violate customer-specific suitability.

FINRA declines one commenter's request to exempt money market mutual funds from all or some of the requirements to gather information when making recommendations. By way of background, the original suitability rule (currently paragraph (a) of NASD Rule 2310) required firms and brokers to have reasonable grounds to believe that the recommendation to purchase, sell, or exchange any security is suitable based upon the facts, if any, disclosed by the customer as to "his other security holdings and as to his financial situation and needs." In 1990, the SEC approved amendments that created a second information-gathering requirement (currently paragraph (b) of NASD Rule 2310).[122] The new paragraph added in 1990 required firms to make reasonable efforts to also obtain the customer's financial status, tax status, investment objectives, and such other information used or considered to be reasonable by such member or associated person in making recommendations to the customer. Transactions involving money market mutual funds were exempted from the requirement under the new paragraph. However, transactions involving money market mutual funds were not exempted from the original suitability requirements under paragraph (a). FINRA believes that recommended money market mutual funds should be subject to the same information-gathering requirements as other recommended securities. That is especially true in light of the problems experienced by the Reserve Primary Fund in late 2008.[123]

Institutional Customer

At present, IM–2310–3 provides a limited exemption from the customer-specific obligation when dealing with institutional customers in certain situations. The proposal continues to provide an exemption, but it adds a requirement that institutional customers provide affirmative acknowledgement of certain aspects of their relationship with the broker-dealer and modifies the definition of institutional customer.

Institutional Customer/Affirmative Acknowledgement Regarding Surrendering Rights

As with the current suitability rule, the proposal provides an exemption from customer-specific suitability regarding institutional customers if the broker-dealer or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently and is exercising independent judgment in evaluating the member's or associated person's recommendations. However, the proposal discussed in the *Notice* seeking comment added as a third requirement that the institutional customer must affirmatively indicate that it is willing to forego the protection

[108] *See* Charles Schwab Letter, *supra* note 47; LPL Letter, *supra* note 49; SIFMA Letter, *supra* note 48; Wells Fargo Letter, *supra* note 63.

[109] *See* FOLIOfn Letter, *supra* note 63.

[110] *See* LPL Letter, *supra* note 49.

[111] *See* LPL Letter, *supra* note 49.

[112] *See* LPL Letter, *supra* note 49.

[113] *See* FOLIOfn Letter, *supra* note 63.

[114] *See* FOLIOfn Letter, *supra* note 63.

[115] *See* FOLIOfn Letter, *supra* note 63.

[116] *See* FOLIOfn Letter, *supra* note 63.

[117] *See* National Planning Holdings, *supra* note 49.

[118] *See* National Planning Holdings, *supra* note 49.

[119] *See* National Planning Holdings, *supra* note 49.

[120] *See* Tamara K. Salmon, Senior Associate Counsel for the Investment Company Institute, June 29, 2009 ("ICI Letter").

[121] *See* ICI Letter, *supra* note 103.

[122] *See* Securities Exchange Act Release No. 27982, 1990 SEC LEXIS 795 (May 2, 1990) (Order Approving Rule Change to Obtain Information Pertinent to Customer Account).

[123] As the SEC explained, "On Sept. 15, 2008, the Reserve Primary Fund, which held $785 million in Lehman-issued securities, became illiquid when the fund was unable to meet investor requests for redemptions. The following day, the Reserve Fund declared it had 'broken the buck' because its net asset value had fallen below $1 per share." *http://www.sec.gov/news/press/2010/2010-16.htm.*

of the customer-specific obligation of the suitability rule.

• Comments

A number of commenters stated that requiring institutional customers to affirmatively acknowledge that they are giving up rights is impractical and will render the institutional exemption ineffective.[124] According to these commenters, this requirement is unnecessary in light of the other two conditions (that the customer be capable of evaluating risks and is exercising independent judgment).[125] The commenters also stated that, because institutional clients are highly unlikely to affirmatively forego suitability protections for commercial reasons, this new requirement will have the practical effect of negating the exemption.[126]

• FINRA's Response

FINRA has modified the proposed exemption in a way that should alleviate commenters' concerns while providing the necessary protection to institutional customers. The revised exemption eliminates the requirement that institutional customers affirmatively indicate that they are giving up suitability protections and focuses on the two main conditions discussed in the current exemption. The revised exemption, however, does require institutional customers to affirmatively indicate that they are exercising independent judgment.

Institutional Customer/Change in Definition

The proposal harmonizes the definition of "institutional customer" in the suitability rule with the more common definition of "institutional account" in NASD Rule 3110(c)(4) [proposed FINRA Rule 4512(c)]. As a result, the monetary threshold for an institutional customer would increase from the current $10 million invested in securities and/or under management to $50 million in assets. In addition, unlike the current exemption, a natural person could qualify as an institutional customer under the proposal.

• Comments

Some commenters supported the change in definition.[127] One commenter stated further that consistent standards produce more efficient, effective, and clear regulation that is beneficial to investors, regulators, and market participants alike.[128] Other commenters, however, disagreed, arguing that the definition of $10 million invested in securities and/or under management in current IM–2310–3 is a more appropriate standard for purposes of the institutional account suitability exemption and should be retained in the new rule rather than referencing the Rule 3110(c)(4) standard of at least $50 million in total assets.[129] According to one commenter, many highly sophisticated institutional brokerage customers would not satisfy the $50 million dollar asset threshold but would not need the protection of the suitability rule.[130]

Another commenter who favored keeping the current standard stated that, if FINRA believes a different standard should be used for uniformity, FINRA should use the definition in NASD Rule 2211(a)(3) (Communications with the Public) rather than the one in NASD Rule 3110(c)(4).[131] Under NASD Rule 2211, institutional sales material may be distributed only to "institutional investors," defined to include several categories of persons, including those identified in NASD Rule 3110(c)(4). It also adds the following entities: Employee benefit plans meeting the requirements of Section 403(b) or Section 457 of the Internal Revenue Code with at least 100 participants, qualified plans with at least 100 participants, and governmental entities or subdivisions thereof. This commenter also suggested that FINRA should make the standard a rebuttable presumption against determining that an entity that is outside the list of plans identified above is an institutional customer.[132]

Finally, one commenter argued that there should not be any exemption for institutional customers.[133] According to this commenter, many institutional customers, even those with $50 million in assets, are not particularly sophisticated about complex securities and need the protections of the suitability rule.[134]

• FINRA's Response

While any standard is imperfect, FINRA believes that it is important to use the definition in Rule 3110(c)(4) for consistency and because of its higher monetary threshold. FINRA does not believe that it is appropriate to use the much broader definition in NASD Rule 2211(a)(3), which defines "institutional investor" for purposes of the rules governing communications with the public. Communications that are distributed or made available only to institutional investors qualify as institutional sales material, which is not subject to the same content, principal approval and filing requirements as communications that are distributed or made available to retail investors. The communication rules' requirements, while important, serve a different purpose than the sales-practice protections that the suitability rule provides when a broker-dealer recommends a security to a customer.

FINRA understands the concern that even some institutional customers with $50 million in assets might be unsophisticated about complex securities and need the protections of the suitability rule. However, the exemption would not apply in that circumstance. Again, the broker-dealer or associated person must have a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently and, under the modified proposal, the customer must affirmatively state that it is exercising independent judgment in evaluating the recommendations.

Institutional Customer/Eliminating Detailed Discussion From IM–2310–3

Although the focus is the same, the proposed institutional exemption is considerably shorter in length than the current one. Its brevity generated one comment.

• Comments

One commenter viewed the new, abbreviated institutional investor discussion in the proposal as a "box check" waiver that provides less protection than the detailed discussion in IM–2310–3 of considerations for determining whether the exemption should apply.[135]

• FINRA's Response

The proposed institutional investor discussion, while shorter than the

[124] *See* Hancock, MetLife and Prudential Letter, *supra* note 51; NAIBD Letter, *supra* note 63; NSCP Letter, *supra* note 35; SIFMA Letter, *supra* note 48; Wells Fargo Letter, *supra* note 63.

[125] *See* NAIBD Letter, *supra* note 63; SIFMA Letter, *supra* note 48; Wells Fargo Letter, *supra* note 63.

[126] *See* Hancock, MetLife and Prudential Letter, *supra* note 51; NAIBD Letter, *supra* note 63; NSCP Letter, *supra* note 35; SIFMA Letter, *supra* note 48; Wells Fargo Letter, *supra* note 63.

[127] *See* SIFMA Letter, *supra* note 48; Wells Fargo Letter, *supra* note 63.

[128] *See* SIFMA Letter, *supra* note 48.

[129] *See* Hancock, MetLife and Prudential Letter, *supra* note 51; NAIBD Letter, *supra* note 63; NSCP Letter, *supra* note 35.

[130] *See* NAIBD Letter, *supra* note 63.

[131] *See* Hancock, MetLife and Prudential Letter, *supra* note 51.

[132] *See* Hancock, MetLife and Prudential Letter, *supra* note 51. In addition, one commenter stated that the exemption should apply to all suitability obligations and should not, as previously had been the case, be limited to customer-specific suitability. *See* SIFMA Letter, *supra* note 48. FINRA believes that the exemption should remain focused on customer-specific suitability. For instance, it remains important that brokers understand the securities they recommend and that those securities are appropriate for at least some investors.

[133] *See* Mougey and Kraszewski Letter, *supra* note 44.

[134] *See* Mougey and Kraszewski Letter, *supra* note 44.

[135] *See* NASAA Letter, *supra* note 34.

current version in IM–2310–3, contains certain stricter standards. In addition to the two main considerations used in both versions, the proposal includes an increased monetary threshold that certain institutions must meet to qualify for the exemption and, even more important, a requirement that the institution affirmatively indicate that it is independently evaluating the firm's recommendations.

Supplementary Material

The Consolidated FINRA Rulebook uses supplementary material to discuss certain aspects of a rule's requirements in greater detail. However, a number of commenters raised issues regarding the supplementary material.

• Comments

A number of commenters supported codifying various interpretations of the suitability rule.[136] Some commenters, however, believed that FINRA should modify some of those interpretations. For instance, one commenter questioned the "three-pronged approach" to suitability discussed in Supplementary Material .02, which codifies discussions in IMs and case law about reasonable-basis suitability, customer-specific suitability, and quantitative suitability. This commenter suggested that the approach created new standards that provide less protection to customers.[137] This commenter took particular issue with reasonable-basis suitability, which requires a broker-dealer to have a reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for at least some investors.[138] The commenter believed that a member's familiarity with a product should be presumed.[139]

Two other comments focused on quantitative suitability, which requires a broker-dealer that has actual or de facto control over an account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. These commenters believed that FINRA should eliminate the requirement under quantitative suitability that a broker-dealer have "control" over an account before the obligation applies.[140] Yet another commenter stated that FINRA should eliminate supplementary material from all rules and limit rulemaking to rule text.[141]

• FINRA's Response

FINRA believes that supplementary material is an important means of providing greater specificity to a rule's overarching requirements. FINRA notes that supplementary material will be filed with the SEC and is enforceable to the same extent as the main rule text.

With regard to the codification of the main suitability obligations, FINRA disagrees with the contention that the discussion creates new standards that provide less protection to customers. The discussion at issue codifies existing interpretations of suitability obligations, often directly from IMs following NASD Rule 2310[142] and case law.[143] The commenter argued that presuming that firms and associated persons are familiar with the products they recommend would provide greater protection to customers. FINRA believes the opposite is true, and FINRA's examination and enforcement experience belies the notion that firms and associated persons are always familiar with every recommended product or strategy. The existing duty to perform adequate due diligence to understand the products and strategies that firms and associated persons recommend is of critical importance to the protection of investors.[144] This is especially true in light of the increasing complexity of certain products and strategies.

Elimination of Interpretive Material Following NASD Rule 2310

In connection with the new suitability rule, FINRA proposes eliminating many and modifying some of the IMs that follow NASD Rule 2310. This aspect of the proposal also generated several comments.

• Comments

A few commenters were concerned that the proposal did not include some of the current IMs, especially IM–2310–2.[145] These commenters believe that it is important to maintain the statement in IM–2310–2 that brokers can be disciplined for excessive trading, unauthorized trading, and fraud.[146] One commenter noted in particular that this IM was the only place in the entire NASD conduct rules explicitly prohibiting unauthorized trading.[147]

• FINRA's Response

FINRA continues to believe that most of the current IMs following NASD Rule 2310 should be eliminated or modified because they are no longer necessary. As discussed in detail in Item II.A. of this filing, some are duplicative of other rules and others would be rendered unnecessary by changes proposed in the new suitability rule. For example, as noted in Item II.A., it is well-settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010. Consequently, the elimination of the discussion of unauthorized trading in the IMs following the suitability rule in no way alters the longstanding view that unauthorized trading clearly violates FINRA's rules.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i)

[136] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44; Taurus Letter, *supra* note 44; T.RowePrice Letter, *supra* note 44.

[137] *See* NASAA Letter, *supra* note 34.

[138] *See* NASAA Letter, *supra* note 34.

[139] *See* NASAA Letter, *supra* note 34.

[140] *See* Cornell Letter, *supra* note 44; Estell Letter, *supra* note 69.

[141] *See* FOLIOfn Letter, *supra* note 63.

[142] *See, e.g.,* IM–2310–2(b)(2) (discussing quantitative suitability, also called excessive trading); IM–2310–3 (discussing reasonable-basis and customer-specific suitability).

[143] *See, e.g., James B. Chase,* Securities Exchange Act Release No. 47476, 2003 SEC LEXIS 566, at *17 (Mar. 10, 2003) (involving customer-specific suitability); *Harry Gliksman,* 54 S.E.C. 471, 474–75 (1999) (discussing excessive trading); *Rafael Pinchas,* 54 S.E.C. 331 (1999) (discussing excessive trading and customer-specific suitability); *F.J. Kaufman & Co.,* 50 S.E.C. 164, 168–69 (1989) (discussing both reasonable-basis and customer-specific suitability); *Patrick G. Keel,* 51 S.E.C. 282, 284–87 (1993) (upholding violation of customer-specific suitability); *Dep't of Enforcement* v. *Medeck,* No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *31 (NAC July 30, 2009) (discussing excessive trading); *Dep't of Enforcement* v. *Siegel,* No. C05020055, 2007 NASD Discip. LEXIS 20, at *36–40 (NAC May 11, 2007) (discussing reasonable-basis suitability and due-diligence requirement thereunder), *aff'd,* Securities Exchange Act Release No. 58737, 2008 SEC LEXIS 2459 (Oct. 6, 2008), *aff'd in relevant part,* 592 F.3d 147 (D.C. Cir. Jan. 12, 2010), *cert. denied,* 2010 U.S. LEXIS 4340 (May 24, 2010); *see also Regulatory Notice* 10–22, 2010 FINRA LEXIS 43, at *10–20 (April 2010) (discussing due diligence required for reasonable-basis suitability in context of recommended private offerings); *Notice to Members* 03–71, 2003 NASD LEXIS 81, *5–6 (Nov. 11, 2003) (discussing due diligence requirement for reasonable-basis suitability in context of recommendations of non-conventional investments).

[144] *See F.J. Kaufman & Co.,* 50 S.E.C. at 168–69 (discussing both reasonable-basis and customer-specific suitability); *Siegel,* 2007 NASD Discip. LEXIS 20, at *36–40 (discussing reasonable-basis suitability and due-diligence requirement thereunder); *see also Regulatory Notice* 10–22, 2010 FINRA LEXIS 43, at *10–20 (April 2010) (discussing due diligence required for reasonable-basis suitability in context of recommended private offerings); *Notice to Members* 03–71, 2003 NASD LEXIS 81, *5–6 (Nov. 11, 2003) (discussing due diligence requirement for reasonable-basis suitability in context of recommendations of non-conventional investments).

[145] *See* Cornell Letter, *supra* note 44; Corporate Law Center & Investor Rights Clinic, *supra* note 44; NASAA Letter, *supra* note 34.

[146] *See* Cornell Letter, *supra* note 44; Corporate Law Center & Investor Rights Clinic, *supra* note 44; NASAA Letter, *supra* note 34.

[147] *See* Corporate Law Center & Investor Rights Clinic, *supra* note 44.

as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–FINRA–2010–039 on the subject line.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number SR–FINRA–2010–039. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–FINRA–2010–039 and should be submitted on or before September 9, 2010.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[148]

Florence E. Harmon,

Deputy Secretary.

[FR Doc. 2010–20537 Filed 8–18–10; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–62707; File No. SR–NYSEAmex–2010–79]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by NYSE AMEX LLC Amending Rule 980–Exercise of Options Contracts

August 12, 2010.

Pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 (the "Act")[2] and Rule 19b–4 thereunder,[3] notice is hereby given that, on August 3, 2010, NYSE Amex LLC ("NYSE Amex" or the "Exchange") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

The Exchange proposes to amend Rule 980–Exercise of Options Contracts. The text of the proposed rule change is attached as Exhibit 5 to the 19b–4 form. A copy of this filing is available on the Exchange's Web site at *http://www.nyse.com,* at the Exchange's principal office, at the Commission's Public Reference Room, and on the Commission's Web site at *http://www.sec.gov.*

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to amend Rule 980 in order to extend the cut-off time to submit Contrary Exercise Advices ("CEA")[4] to the Exchange.

The Options Clearing Corporation ("OCC") has an established procedure, under OCC Rule 805, that provides for the automatic exercise of certain options that are in-the-money by a specified amount known as "Exercise-by-Exception" or "Ex-by-Ex." Under the Ex-by-Ex process, options holders holding option contracts that are in-the-money by a requisite amount and who wish to have their contracts automatically exercised need take no further action. However, under OCC Rule 805, option holders who do not want their options automatically exercised or who want their options to be exercised under different parameters than that of the Ex-by-Ex procedures must instruct OCC of their "contrary intention."

In addition to and separately from the OCC requirement, under NYSE Amex Rule 980 option holders must file a CEA with the Exchange notifying it of the contrary intention. Rule 980 is designed, in part, to deter individuals from taking improper advantage of late breaking news by requiring evidence of an option holder's timely decision to exercise or not exercise expiring equity options. ATP Holders[5] satisfy this evidentiary requirement by submitting a CEA form directly to the Exchange, or by electronically submitting the CEA to the Exchange through OCC's electronic communications system. The submission of the CEA allows the Exchange to satisfy its regulatory obligation to verify that the decision to

[148] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C.78s(b)(1).

[2] 15 U.S.C. 78a.

[3] 17 CFR 240.19b–4.

[4] Contrary Exercise Advices are also known as Expiring Exercise Declarations ("EED").

[5] The term ATP refers to an Amex Trading Permit issued by the Exchange for effecting securities transactions on the Exchange. ATP Holders have the status of "member" of the Exchange as that term is defined in Section 3 of the Securities Exchange Act of 1934, as amended.