

MORRISON FOERSTER

FREQUENTLY ASKED QUESTIONS ABOUT FINRA RULE 2111 – SUITABILITY

Introduction to Suitability

What is Rule 2111, and what does it require?

Financial Industry Regulatory Authority, Inc. (“FINRA”) Rule 2111 requires, generally, that FINRA member broker-dealers and associated persons have a reasonable basis to believe that a recommendation is suitable for a customer.

Why is FINRA concerned about suitability?

FINRA states that “[i]mplicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.”

Source: Rule 2111, Supplementary Material .01

What does “suitability” mean?

The suitability obligation has three components:

- The reasonable-basis obligation;
- The customer-specific obligation; and
- Quantitative suitability.

We discuss each of these components in more detail below.

Reasonable-Basis Suitability

What is the reasonable-basis obligation?

The reasonable-basis obligation reflects the principle that there must be an investment theme or rationale for each product, and that the product is not “designed to fail.” FINRA characterizes the reasonable-basis obligation as the requirement that a broker or an associated person must perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and determine whether the recommendation is suitable for at least some investors based on that understanding. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

Source: Rule 2111, Supplementary Material .05(a); FINRA Regulatory Notice 12-25 (“Notice 12-25”).

Does the vetting of a new product by a firm satisfy an associated person’s reasonable-basis obligation?

A firm’s vetting of a new product to determine whether that product meets the reasonable-basis suitability standard for retail customers does not, by itself, mean that an associated person has complied with the reasonable-basis suitability obligation. If the associated

person does not understand the potential risks and rewards associated with the recommended product or strategy, one prong of the reasonable-basis obligation is not satisfied. FINRA views adequate procedures for reviewing new products as an enhancement of a firm's ability to avoid unsuitable recommendations.

Source: FINRA Rule 2111 (Suitability) FAQ, Q5.2; FINRA Regulatory Notice 13-31; NASD Notice to Members 05-26.

Customer-Specific Suitability

What is the customer-specific obligation?

The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that a recommendation of a security or an investment strategy involving a security or securities is suitable for a particular customer based on that customer's investment profile (the customer's objectives, liquidity needs and other factors).

Source: Rule 2111, Supplementary Material .05(b); Notice 12-25.

Please see "*Institutional Customers*" below for a discussion of the exception from the customer-specific obligation for institutional customers.

How do Rule 2111's customer-specific obligation and Know Your Customer Rule 2090 interrelate?

Numerous cases interpreting the predecessor to Rule 2111 (NASD Rule 2310) stated that "a broker's recommendations must be consistent with a customer's best interests." The customer's investment profile is critical to that assessment, as are other product or strategy-related factors.

Rule 2090 requires that every member shall use reasonable diligence, in regard to the opening and

maintenance of every account, to know (and retain) the essential facts concerning every customer. For purposes of Rule 2090, the facts "essential" to "knowing the customer" are those required to:

- Effectively service the customer's account;
- Act in accordance with any special handling instructions for the account;
- Understand the authority of each person acting on behalf of the customer; and
- Comply with applicable laws, regulations and rules.

Please see "*What is a customer's investment profile*" below.

FINRA also views Rule 2090 as one of a number of FINRA's investor protection rules, in addition to Rule 2111. Other FINRA investor protection rules include Rule 2020 (prohibiting the use of manipulative, deceptive or other fraudulent devices); Rule 2330 (heightened suitability requirements regarding variable annuities); Rule 2360 (heightened suitability requirements regarding options); and Rule 2370 (heightened suitability obligations regarding securities futures).¹

Quantitative Suitability

What is the quantitative suitability obligation?

The quantitative suitability obligation requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis to believe that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when

¹ This FAQ does not discuss the suitability requirements imposed by Rules 2330, 2360 and 2370.

taken together in light of the customer's investment profile. Excessive trading or "churning" of a customer's account may also constitute a violation of the anti-fraud provisions of federal and state securities laws.

Source: Rule 2111, Supplementary Material .05(c).

So Many Terms, What Do They Mean?

Rule 2111 contains many terms of art, all of which have been extensively discussed by FINRA over the years.

What is a customer?

The term "customer," as defined in FINRA Rule 0160(b)(4), excludes a broker-dealer. For purposes of Rule 2111, a "customer" includes "a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer's affiliate or a custodial agent ..., or using another similar arrangement"

Source: FINRA Rule 2111 (Suitability) FAQ, Q2.1.

What is a recommendation?

The determination of whether a particular communication constitutes a recommendation is a "facts and circumstances" inquiry – the term is not defined. Some of FINRA's guiding principles in determining whether a recommendation has been made are:

- What is the communication's content, context and presentation?

- Given a communication's content, context and manner of presentation, could the particular communication reasonably be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or an investment strategy?
- The more individually tailored the communication is to a particular customer, or customers, about a specific security or investment strategy, the more likely that the communication will be viewed as a recommendation.
- A series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when viewed in the aggregate.

Source: FINRA Rule 2111 (Suitability) FAQ, Q1.1; FINRA Regulatory Notice 11-02.²

What is an investment strategy?

As used in Rule 2111, the phrase "investment strategy involving a security or securities" is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities.

Source: Rule 2111, Supplementary Material .03.

² This FAQ does not discuss the potential implications of several schemes afoot to impose a fiduciary duty on broker-dealers. Under the new Department of Labor fiduciary regulations under the Employee Retirement Income Security Act of 1974 ("ERISA"), making an investment recommendation to a plan subject to ERISA would constitute "investment advice." The broker-dealer giving the investment advice, under the proposed rule and subject to certain exceptions, would be subject to a fiduciary standard with respect to its customer. Similarly, the Securities and Exchange Commission, pursuant to the Dodd-Frank Act, is considering a uniform fiduciary standard for broker-dealers and investment advisers.

If a recommended investment strategy does not result in a securities transaction, is it still an investment strategy for purposes of Rule 2111?

Yes. Rule 2111 would cover a recommendation to purchase securities using margin or liquefied home equity or to engage in day trading, irrespective of whether the recommendation results in a transaction or references particular securities.

Source: FINRA Rule 2111 (Suitability) FAQ, Q4.1.

Would a registered representative's recommendation of an investment strategy involving both securities and non-securities be within the scope of Rule 2111?

Yes. For example, a recommendation of an investment strategy to use home equity to purchase securities or to liquidate securities to purchase an investment-related product would be within the scope of Rule 2111.

If a customer, absent a recommendation by a registered representative, decided on its own to purchase a non-security investment and then asks the registered representative to recommend which securities the customer should sell to purchase the non-security investment, Rule 2111 would apply to the registered representative's recommendation regarding the securities to sell but not to the customer's decision to purchase the non-security investment.

Source: FINRA Rule 2111 (Suitability) FAQ, Q4.3.

Does Rule 2111 create an ongoing obligation to monitor a customer's transactions and make subsequent recommendations?

No. The Rule's focus is on whether the recommendation was suitable when it was made (regardless of whether a transaction occurs). Absent an agreement, course of conduct or unusual fact pattern

that might alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.

Source: FINRA Rule 2111 (Suitability) FAQ, Q4.2 and note 15.

Must a broker-dealer comply with Rule 2111 when making a recommendation to a potential investor that is not a customer of the broker-dealer?

Yes, if the potential investor then becomes a customer of that broker-dealer (the investor executes the transaction through the broker-dealer with which the registered representative is associated or the broker-dealer receives or will receive, directly or indirectly, compensation as a result of the recommended transaction). Suitability obligations attach when the transaction occurs, but the suitability of the recommendation is evaluated based on the circumstances that existed when the recommendation was made.

If the potential investor does not act on the recommendation or executes the recommended transaction away from the broker-dealer with which the registered representative is associated without the broker-dealer receiving compensation for the transaction, then Rule 2111 would not apply to the recommendation. (Depending on the facts and circumstances, other FINRA rules might apply to a recommendation to a potential investor that does not become a customer: Rule 2010 (Standards of Commercial Honor and Principles of Trade); Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices); Rule 2210 (Communications with the Public);

and Rule 3280 (Private Securities Transactions of an Associated Person).)

Source: FINRA Rule 2111 (Suitability) FAQ, Q2.2. and notes 15 and 16.

Are there any particular kinds of postings on social media by a member firm that would not constitute a recommendation subject to Rule 2111?

Yes. The following examples are not considered by FINRA to be recommendations (this list is not intended to cover all online non-recommendations):

- A member creates a website that is available to customers or groups of customers. The website has research pages or “electronic libraries” that contain research reports (which may include buy/sell recommendations from the author of the report), news, quotes, and charts that customers can obtain or request.
- A member has a search engine on its website that enables customers to sort through the data available about the performance of a broad range of stocks and mutual funds, company fundamentals, and industry sectors. The data is not limited, for instance, to, and does not favor, securities in which the member makes a market or has made a “buy” recommendation. Customers use and direct this tool on their own. Search results from this tool may rank securities using any criteria selected by the customer, and may display current news, quotes, and links to related sites.
- A member provides research tools on its website that allow customers to screen through a wide universe of securities (*e.g.*, all exchange-listed and Nasdaq securities) or an externally

recognized group of securities (*e.g.*, certain indexes) and to request lists of securities that meet broad, objective criteria (*e.g.*, all companies in a certain sector with 25 percent annual earnings growth). The member does not impose limits on the manner in which the research tool searches through a wide universe of securities, nor does it control the generation of the list in order to favor certain securities. For instance, the member does not limit the universe of securities to those in which it makes a market or for which it has made a “buy” recommendation. Similarly, the algorithms for these tools are not programmed to produce lists of securities based on subjective factors that the member has created or developed, nor do the algorithms, for example, produce lists that favor those securities in which the member makes a market or for which the member has made a “buy” recommendation.

- A member allows customers to subscribe to e-mails or other electronic communications that alert customers to news affecting the securities in the customer’s portfolio or on the customer’s “watch list.” Such news might include price changes, notice of pre-scheduled events (such as an imminent bond maturation), or generalized information. The customer selects the scope of the information that the firm will send to him or her.

Source: NASD Notice to Members 01-23.

Determining a Customer's Investment Profile

What is a customer's investment profile?

A recommended transaction must be suitable for a particular customer based on information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is 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 that the customer may disclose to the member or associated person in connection with a recommendation.

Source: Rule 2111(a)

How should a dealer perform reasonable diligence to obtain a customer's investment profile?

Asking a customer for investment profile information will suffice, depending on the facts and circumstances. A broker or associated person must use reasonable diligence to obtain all of the investment profile factors listed above. However, the level of importance of each factor may vary depending on the facts and circumstances of the particular case.

Source: Rule 2111, Supplementary Information .04; FINRA Rule 2111 (Suitability) FAQ, Q3.5.

Does a broker or associated person always have to obtain all of the customer's investment profile factors?

No. If the broker or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of the customer's investment profile, in light of the facts and circumstances of the particular case, then the broker or associated person does not have to obtain that investment factor.

Source: Rule 2111, Supplementary Information .04.

Institutional Customers

Does a broker have to satisfy the customer-specific suitability obligation for institutional purchasers?

No, provided that three criteria are satisfied:

- The customer must meet the FINRA Rule 4512(c) definition of an "institutional account";
- The member firm must 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 involving a security or securities; and
- The institutional customer must affirmatively indicate that it is exercising independent judgment in evaluating the member's or associated person's recommendations.

Where an institutional customer has delegated decision making authority to an agent, such as an investment adviser, the factors above will be applied to the agent.

Source: Rule 2111(b)

What is required in connection with an institutional customer's affirmation that it is exercising independent judgment?

An institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis or in terms of all potential transactions for its account.

Although FINRA has explicitly stated that it does not endorse or approve forms of certificates marketed by third-party vendors designed to evidence compliance with the Rule 2111(b) independent judgment affirmation, member firms generally obtain a written affirmation from the institutional customer for risk management purposes.

Examples of documentation that could include the written affirmation provided by FINRA include having the institutional customer affirm in writing that it will be exercising independent judgment, or the member firm documenting a telephone conversation in which the institutional customer affirms that it will be exercising independent judgment.

Source: Rule 2111, Supplementary Material .07; FINRA Regulatory Notice 13-31; FINRA Rule 2111 (Suitability) FAQ, Q8.1 and 8.3.

Is a firm required to document its suitability determinations?

No, other than under a general obligation to evidence compliance with the applicable FINRA rules. Rule 2111 does not include any specific documentation requirements. A firm may take a risk-based approach regarding documentation of its compliance with Rule 2111. The extent to which a firm needs to evidence suitability generally depends on an assessment of the customer's investment profile and the complexity of the

recommended security or investment strategy involving a security or securities (in terms of both its structure and potential performance) and/or the risks involved. For example, FINRA has stated that a recommendation of a large-cap, value-oriented equity security usually would not require documentation; but a recommendation of a complex and/or particularly risky security or investment strategy involving a security or securities would require documentation.

Compliance with the suitability obligation does not necessarily turn on whether the basis for the determination was properly documented. Documentation itself does not cure an otherwise unsuitable recommendation.

Source: FINRA Rule 2111 (Suitability) FAQ, Q9.1.

May a dealer or associated person disclaim their responsibilities under Rule 2111?

No.

Source: Rule 2111, Supplementary Material .02.

Suitability Determinations and Complex Products

FINRA has issued a number of notices and other communications regarding the suitability determination as it relates to recommendations of various specific types of complex products, including:

- Asset-backed securities that are secured by collateral that may be difficult for a customer to understand;
- Products with an embedded derivative component that also may be difficult to understand, such as reverse convertible notes or notes with knock-in or knock-out features;

- Products with contingencies in gains or losses, such as range accrual notes that measure more than one underlying asset;
- Structured notes with “worst of” features;
- Investments tied to markets that are not well understood by investors, such as the CBOE VIX Index; and
- Products that are not fully principal protected.

As noted in Rule 2111, Supplementary Material .05(a), the lack of an understanding of the potential risks and reward of an investment strategy when recommending that strategy is a violation of Rule 2111. Consequently, FINRA has emphasized that there are heightened suitability standards for complex products and has focused on the following areas with respect to suitability determinations for recommendations of complex products:

- Formal written procedures to ensure that complex products are not recommended to customers prior to a thorough vetting;
- Training of registered representatives; and
- Consideration of a customer’s financial sophistication.

Source: FINRA Regulatory Notice 12-03.

What types of questions should a firm ask prior to recommending a complex product to retail investors?

The following questions should be answered prior to a recommendation of a complex product to retail investors:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled?

- Conversely, to whom should this product not be offered?
- What is the product’s investment objective and is that investment objective reasonable in relation to the product’s characteristics? How does the product add to or improve the firm’s current offerings? Can less complex products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they? How is the product expected to perform in a wide variety of market or economic scenarios? What market or performance factors determine the investor’s return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- Does the product present any novel legal, tax, market, investment or credit risks?
- Does the product’s complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations or the training requirements associated with the product?

- How liquid is the product? Is there an active secondary market for the product?

Source: Regulatory Notice 12-03

What type of training should a registered representative undergo prior to recommending a complex product?

The registered representative should be able to develop a payoff diagram of a structured product to facilitate his or her analysis of its embedded features and recognize that the structured product can be decomposed into a bond and derivative parts. That knowledge, however, is not the equivalent of an understanding of the risks of the structured product. The registered representative should not only understand the manner in which the structured product is intended to perform in normal market conditions, but also the risks associated with the structured product. The registered representative should also understand such features as:

- The characteristics of the reference asset;
- The reference asset's historic performance and volatility and its correlation with specific asset classes;
- Any interrelationship between multiple reference assets;
- The likelihood of a call by the issuer; and
- The extent and limitations of any principal protection.

Source: Regulatory Notice 12-03

Are there any specific procedures for satisfying the customer-specific obligation prior to recommending a complex product?

Yes. As part of determining a customer's investment experience and risk tolerance, FINRA encourages firms to adopt the approach mandated for options trading

accounts when making a recommendation of a complex product. Under FINRA Rule 2360(b)(19)(B), a registered representative must have "a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract." FINRA advises that this same approach be taken for a recommendation of a complex product.

Source: FINRA Regulatory Notice 12-03; FINRA Rule 2360(b)(19)(B).

Should a firm limit the type of customer to which it recommends complex products?

Firms should consider placing limitations on customers who might be eligible to purchase complex products. FINRA specifically approves the use of investment concentration limitations or limitations on the type of investors to whom products may be sold. FINRA also approves of the practice of prequalifying retail investors through specialized investor qualification agreements that may explain the products' risks in plain English and which may include an attestation that the customer has read the materials provided, understands the risks and still wants to invest in the product. A thorough, customer-specific suitability analysis would still be required, even with a prequalification agreement in place.

Source: FINRA Regulatory Notice 12-03

May a firm recommend a complex product to a retail investor?

Yes; however, FINRA suggests that firms consider prohibiting their sales forces from recommending complex products to retail investors who have not been approved for options trading. FINRA's concerns are stronger when the complex product contains an embedded option or derivative. These types of recommendations should be supervised by a specially qualified supervisor.

Source: FINRA Regulatory Notice 12-03.

May a firm recommend a complex product to a retail investor that is not approved for options trading?

Yes; however, such firms should develop other comparable procedures to ensure that their sales force does not solicit retail investors for products that are unsuitable. These firms should be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors whose accounts are not approved for options trading. A firm's approval of a retail customer's account for the purchase of complex products is not a substitute for a thorough suitability analysis.

Source: FINRA Regulatory Notice 12-03.