



FINRA Updates Guidance on its Suitability Rule

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December 2012

In its [Regulatory Notice 12-55](#), the Financial Industry Regulatory Authority ("FINRA") has updated its guidance on FINRA Rule 2111 concerning suitability. This is FINRA's fourth regulatory notice concerning the rule -- it previously published [Regulatory Notice 12-25](#), [Regulatory Notice 11-25](#), and [Regulatory Notice 11-02](#) -- but this notice takes the rule in a slightly different direction, at least appearing to soften enforcement of the rule. This guidance is important to brokers and advisors, particularly because Rule 2111 is reported to have been the "most common ground for disciplinary action this year."¹

Rule 2111 requires, in pertinent part, that "[a] member or an associated person must have a reasonable basis to believe that a recommended transaction or **investment strategy** involving a security or securities is suitable for the **customer**, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile." The rule goes on to clarify that "[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 the customer may disclose to the member or associated person in connection with such recommendation." It is based on NASD Rule 2310.

In its December 2012 notice, FINRA made two central updates and clarifications by further defining and explaining the terms "customer" and "investment strategy." First, FINRA specified that the term **customer** excludes a broker or dealer and a potential investor that "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." While FINRA took care to note that this change did not lessen the reach of other FINRA rules, the narrowing of the definition of customer is a substantial change in the application of Rule 2111.

The second central clarification involves the term **investment strategy**. Regulatory Notice 12-55 clarifies that while the term investment strategy is still intended to be interpreted broadly, the term does not include a recommendation that a customer "generally invest in 'equity' or 'fixed income' securities," does not include implicit recommendations to hold a security, and focuses on whether a recommendation was suitable at the time it was made. On the other hand, investment strategy does include recommendations to invest in certain types of securities and instances when there is an explicit recommendation to hold securities or to continue to use a particular investment strategy.

In addition to the above clarifications, Regulatory Notice 12-55 adds the guidance that a broker-dealer's supervisory system "must be reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules." As FINRA notes, however, this will depend in large part on the facts and circumstances of any given situation.

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¹ <http://www.onwallstreet.com/news/FINRA-Clarifies-Suitability-Terms-2682352-1.html>;
http://www.onwallstreet.com/ows_issues/2012_9/finra-penalties-soar-in-2012-2680488-1.html.



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