The Legal Intelligencer

FINRA's New Suitability Rule 2111: Documenting Compliance and Mitigating Litigation Risk

The Financial Industry Regulatory Authority (FINRA) recently implemented a new securities industry rule governing the obligation of broker-dealers and their registered representatives (brokers) to make "suitable" investment recommendations to customers. FINRA Rule 2111, which went into effect on July 9, broadens the scope of the predecessor suitability rule, NASD Rule 2310, in a number of important respects. This article highlights the key provisions of FINRA's new suitability rule and recommends a number of ways to document compliance and mitigate litigation risk.

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The Suitability Obligation

The requirement that brokers may only recommend suitable investments is not new. Customer unsuitability claims have been litigated for years. Customer disputes against brokerage firms are typically litigated through arbitration before industry-sponsored arbitration panels with FINRA dispute resolution. The arbitrations frequently involve claims by customers that they should be compensated for their investment losses because their brokers recommended unsuitable investments. According to FINRA dispute resolution, about one-third of the arbitration claims filed with FINRA involved customer claims for unsuitability. The suitability rule is intended to promote ethical sales practices and high standards of professional conduct among brokers when dealing with investors. The purpose of the suitability rule is to protect customers from potentially abusive sales practices by ensuring that brokers have reasonable grounds for believing that their investment recommendations are appropriate for their customers. See *Siegel v. SEC* , 592 F.3d 147 (D.C. Cir. 2010). The suitability requirement is triggered when the broker makes an investment "recommendation." The courts have found that communications objectively viewed as a "call to action" constitute recommendations triggering the suitability rule. The suitability rule's focus is on whether the recommendations were suitable at the time they were made.

Three Types of Suitability Under New Rule

FINRA Rule 2111(a) provides that brokers "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." FINRA has issued several regulatory releases offering interpretive guidance for the new rule. See FINRA Regulatory Notices 11-02 (January 2011), 11-25 (May 2011) and 12-25 (May 2012). Among other things, the new rule codifies three types of suitability that have been addressed in the case law: (1) reasonable-basis suitability; (2) customer-specific suitability; and (3) quantitative suitability.

- **Reasonable-Basis Suitability**

Reasonable-basis suitability means that a broker must perform reasonable diligence to understand the investment products and strategies that he or she recommends to customers. Firms must ensure through proper supervisory and compliance procedures that their brokers are complying with this obligation through training and other ways to educate themselves about the investment products and strategies they recommend. FINRA's interpretive releases also make clear that a broker's lack of understanding about a securities product or investment strategy that he or she recommends may alone violate the new suitability rule, even where the recommendation is otherwise appropriate for the customer.

- **Customer-Specific Suitability**

Customer-specific suitability means that a broker must have a reasonable basis to believe that his or her recommendations are suitable for a customer based on the customer's "investment profile." The new rule sets forth a non-exhaustive list of customer-specific information that the broker should endeavor to obtain from a customer to understand his or her investment profile: the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance. This represents an expansion of the specific factors listed under the old suitability rule. The new list of customer-specific factors will generally make up a customer's investment profile for the purposes of the suitability analysis.

- **Quantitative Suitability**

Quantitative suitability means that a broker who has control over a customer's account (such as a discretionary trading account or de facto control) must have a reasonable basis to believe that a series of recommended securities transactions is not excessive. The quantitative suitability obligation is a codification of the excessive trading principle addressed in the case law. This principle provides that a broker should reasonably believe that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive or otherwise unsuitable for the customer.

Additional Requirements Under New Rule

In addition to codifying several suitability concepts from the case law, FINRA's new suitability rule adds several new concepts. First, the new rule encompasses recommendations concerning securities transactions as well as investment strategies. FINRA cautions that investment strategies should be interpreted broadly to include "explicit" recommendations to "hold" investments. FINRA explains in the interpretive guidance that it is appropriate for firms and brokers to be responsible for all customer recommendations, regardless of whether the recommendations result in transactions or generate transaction-based compensation.

Second, the suitability obligation under the new rule is not limited to customers who open accounts with the firm. It also covers individuals and entities with whom the broker may have an informal business relationship related to brokerage services. This includes recommendations to prospective customers even if they never open an account with the firm.

Third, although the new rule still recognizes an exemption for recommendations to institutional investors, the new rule requires that brokers now obtain an affirmative indication from institutional investors that they are exercising independent judgment with respect to brokers' recommendations.

Documenting Compliance and Mitigating Litigation Risk

Firms need to understand the broader scope of FINRA's new suitability rule in order to effectively document compliance and mitigate litigation risk. One way to do this is to require brokers to adequately record their communications with customers, including prospective customers. This is true notwithstanding the fact that the interpretive guidance states that the new rule does not impose explicit documentation requirements. The best practice, however, with respect to documenting compliance and mitigating litigation risk, is to record in reasonable detail the broker's suitability analysis. This can be done in any number of ways. For example, firms should ensure that brokers are carefully taking notes of their meetings and communications with both clients and prospective clients. Such notes should be legible, created at the time of the meetings and properly retained by the firm. Unsuitability claims are frequently decided based on the existence of a broker's records concerning his or her initial meetings with a potential customer.

The records should reflect whether the broker made a recommendation (that is, "a call to action"). If so, the records should reflect that the broker (1) understood the securities products or investment strategies he or she recommended; (2) asked for and understood the customer's investment profile; (3) and made recommendations consistent with (1) and (2). The notes should be retained by the firm (the filing cut-off for customer securities arbitration claims is six years), and the notes should be reviewed by compliance and supervisory personnel.

In addition, firms should consider reviewing and, if necessary, updating their standard account-opening documents to make sure they are seeking sufficient information from customers to fully understand their investment profiles. Many account-opening documents offer customers the opportunity to check boxes with regard to such important information as investment experience and risk tolerance. FINRA offers a New Account Application Template that contains a number of standard questions for customers to answer that are relevant to a broker's understanding of the customer's investment profile. The template, which is available on FINRA's website, can serve as a roadmap to the types of questions FINRA expects brokers to ask customers as part of their suitability analysis. Brokers should also be asking prospective customers, if relevant, why they are seeking to change brokers or investment strategies. If customers provide this information in written communication, such as emails, this too should be maintained, along with the broker's notes and any account-opening documents. In litigation, such documentation is invaluable when defending brokerage firms against customer unsuitability claims.

In addition, firms must now consider how to document compliance with the new suitability rule for "hold" recommendations. The new rule, however, does not prescribe the manner in which a firm must document hold recommendations. FINRA has suggested that firms may consider using hold tickets or adding a hold section to existing order tickets, or require emails or memoranda to supervisors concerning hold recommendations. Firms may also consider data fields for entering the relevant information into automated supervisory systems. Whatever method firms choose to document the suitability of hold recommendations, the methods must be reasonably designed to achieve compliance consistent with NASD Rule 3010.

The exact form, degree and level of specificity of the notes and other records documenting compliance with the new suitability rule will depend on the nature of the firm's business model, products and services offered, investment strategies and customer base. As a general rule, however, the more complex and risky the security or investment strategy, the more documentation is necessary to ensure compliance with the new suitability rule and to mitigate litigation risk. FINRA has issued a number of regulatory notices discussing suitability and other fair dealing obligations of firms and brokers when recommending complex and risky investment products, such as private offerings, leverage and inverse exchange-traded funds, and variable deferred annuities. The new suitability rule complements, but does not repeal, the prior and product-specific guidance. •

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