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 No. SR–ISE–2010–103 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–ISE–2010–103. 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 Commissions 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. Copies of such filing also will be available for inspection and copying at the principal office of the ISE. 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–ISE–2010–103 and should be submitted by December 14, 2010.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[14]

Florence E. Harmon,

Deputy Secretary.

[FR Doc. 2010–29402 Filed 11–22–10; 8:45 am]

BILLING CODE 8011–01–P

[14] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–63325; File No. SR–FINRA–2010–039]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 to a Proposed Rule Change and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, To Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook

November 17, 2010.

I. Introduction

On July 30, 2010, the 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"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Exchange Act") [1] and Rule 19b–4 thereunder,[2] a proposed rule change to adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability) in the consolidated FINRA rulebook ("Consolidated FINRA Rulebook").[3] The Commission published the proposed rule change in the Federal Register.[4]

The Commission received 22 comments in response to the proposed rule change.[5] On September 21, 2010, FINRA responded to the comments [6] and filed Amendment No. 1 to the proposed rule change.[7] The Commission is publishing this notice and order to solicit comments on Amendment No. 1 and to approve the proposed rule change, as amended, on an accelerated basis.

II. Description of the Proposed Rule Change

As part of the process of developing the Consolidated FINRA Rulebook, FINRA proposed FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). The "know your customer" and suitability obligations are critical to ensuring investor protection and fair dealing with customers. FINRA's proposed rule change was designed to retain the core features of these obligations (set forth in NYSE Rule 405(1) and NASD Rule 2310), while modifying both rules to strengthen and clarify them.

The proposed rule change built on a similar proposed rule change on which

[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"). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

[4] *See* Exchange Act Release No. 62718 (August 13, 2010), 75 FR 51310 (August 19, 2010). This release was later amended to correct footnote cross-references. Exchange Act Release No. 62718A (August 20, 2010), 75 FR 52562 (August 26, 2010). The Commission also published the corrected notice on its Web site.

[5] *See* Letters from Steven B. Caruso, Maddox Hargett & Caruso, P.C. (Sept. 8, 2010) ("Caruso Letter"); Barry D. Estell, Attorney (Sept. 9, 2010) ("Estell Letter"); Barbara Black, Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law, and Jill I. Gross, Professor of Law and Director of Legal Skills and Director, Pace Investor Rights Clinic, Pace University School of Law (Sept. 9, 2010) ("Black-Gross Letter"); David P Neuman, Stoltmann Law Offices, PC (Sept. 9, 2010) ("Neuman Letter"); Richard M. Layne (Sept. 9, 2010) ("Layne Letter"); William A. Jacobson, Associate Clinical Professor of Law, Cornell Law School, and Director, Cornell Securities Law Clinic (Sept. 9, 2010) ("Jacobson Letter"); Scott R. Shewan, President, Public Investors Arbitration Bar Association (Sept. 9, 2010) ("PIABA Letter"); Pamela Lewis Marlborough, Associate General Counsel, Advocacy & Oversight, TIAA–CREF (Sept. 9, 2010) ("TIAA–CREF Letter"); Gary A. Sanders, Vice President, Securities and State Government Relations, National Association of Insurance and Financial Advisors (Sept. 9, 2010) ("NAIFA Letter"); Stephen Krosschell, Goodman Nekvasil, P.A. (Sept. 9, 2010) ("Krosschell Letter"); Sutherland Asbill & Brennan LLP, on behalf of the Committee of Annuity Insurers (Sept. 9, 2010) ("CAI Letter"); Lisa Catalano, Director, St. John's University School of Law Securities Arbitration Clinic, (Sept. 9, 2010) ("Catalano Letter"); G. Mark Brewer, Esquire (Sept. 9, 2010) ("Brewer Letter"); Bari Havlik, SVP and Chief Compliance Officer, Charles Schwab & Co. Inc. (Sept. 9, 2010) ("Schwab Letter"); Peter J. Mougey, Levin, Papantonio, Thomas, Mitchell, Echsner, Rafferty, Proctor, P.A. (Sept. 9, 2010) ("Mougey Letter"); Al Van Kampen, Esquire (Sept. 10, 2010) ("Van Kampen Letter"); James T. McHale, Managing Director and Associate General Counsel, SIFMA (Sept. 14, 2010) ("SIFMA Letter"); John S. Markle, Deputy General Counsel, TD Ameritrade (Sept. 15, 2010) ("TD Ameritrade Letter"); Scott C. Ilgenfritz, Johnson, Pope, Bokor, Ruppel & Burns, LLP (Sept. 24, 2010) ("Ilgenfritz Letter"); Dale E. Brown, President and CEO, Financial Services Institute, Inc. (Sept. 27, 2010) ("FSI Letter"); Timothy R. Wing, President and CEO, CME Stock/Option Consulting Services, Inc. (Sept. 28, 2010) ("CME/OCS Letter").

[6] *See* Letter from James Wrona, Associate Vice President and Associate General Counsel, FINRA to Elizabeth M. Murphy, Secretary, Commission, dated October 21, 2010 ("FINRA Response").

[7] *See* Amendment No. 1 to FINRA–2010–039, dated October 21, 2010 ("Amendment No. 1"). The text of Amendment No. 1 is available on FINRA's Web site at *http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p122318.pdf,* at the principal office of FINRA, and on the Commission's Internet Web site (*http://www.sec.gov/rules/sro/finra.shtml*).

FINRA requested comment in FINRA *Regulatory Notice* 09–25 (May 2009). The proposed rule change FINRA filed with the Commission included both a comprehensive response to the comments FINRA received in response to *Regulatory Notice* 09–25 and modifications to address those comments.

A. Proposed FINRA Rule 2090

The proposed "Know Your Customer" obligation in FINRA Rule 2090 encompasses the main ethical standard of NYSE Rule 405(1). As proposed, the rule would require broker-dealers to use "reasonable diligence," with regard to the opening and maintenance of every account, in order to know and retain the essential facts concerning every customer.[8] The obligation would arise at the beginning of the customer/broker relationship, independent of whether the broker has made a recommendation, and continue throughout the term of that relationship. 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."[9]

The proposal would not incorporate the requirement in NYSE Rule 405(1) to learn the essential facts relative to "every order." FINRA proposed to exclude the "every order" language because of the application of existing order-handling rules.[10] In addition, the reasonable-basis obligation under FINRA's suitability rule requires broker-dealers and their associated persons to use reasonable diligence to understand the securities and strategies they recommend.

FINRA also proposed to delete NYSE Rule 405(2) through (3), NYSE 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.[11]

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 prior to approving the opening of the account. However, FINRA believes that a number of other FINRA rules do, and proposed FINRA rules would, create substantially similar obligations. For example, proposed FINRA Rule 2090 would require members to know the essential facts as to each customer, and NASD Rule 3110(c)(1)(C) requires the signature of the member, partner, officer or manager who accepts the account.[12]

FINRA Rule 3310, which requires a firm to have procedures reasonably designed to achieve compliance with the Bank Secrecy Act ("BSA") and the implementing regulations, also affect a firm's account-opening obligations. One BSA regulation requires a firm to verify the identity of a customer opening a new account.[13] Another BSA regulation requires a firm to engage in due diligence sufficient to enable the firm to evaluate the risk of each customer and to determine if transactions by the customer could be suspicious such that the firm would need to file a suspicious activity report.[14]

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.[15]

FINRA also believes that NYSE Supplementary Material 405.10 is redundant of other FINRA proposed and existing requirements, and that the cross references provided in NYSE Supplementary Material 405.20 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. As discussed above, proposed FINRA Rule 2090 and proposed FINRA Supplementary Material 2090.01 would require firms to know the essential facts concerning every customer. Moreover, NASD Rule 3110(c) (Customer Account Information), requires firms to maintain a record identifying the person(s) authorized to transact business on behalf of a customer that is a legal entity.[16] 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.

FINRA believes that the associated 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 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) provides 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 would similarly require 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, existing FINRA rules address currently these activities. FINRA Rule 5210 (Publication

[8] *See* Proposed FINRA Rule 2090.

[9] *See* Proposed FINRA Rule 2090.01. FINRA proposed to change the explanation of "essential facts" in response to comments.

[10] *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); NASD Rule 2400 Series (Commissions, Mark-Ups and Charges); NASD IM–2110–2 (Trading Ahead of Customer Limit Order); and IM–2110–3 (Front Running Policy). *See also,* FINRA *Regulatory Notice* 08–80 (December 2008) (proposed FINRA Rule 5310); FINRA *Regulatory Notice* 08–83 (December 2008) (proposed FINRA Rule 5270); and Exchange Act Release No. 61168 (December 15, 2009) (proposed FINRA Rule 5320).

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

[12] FINRA is proposing to adopt NASD Rule 3110(c)(1)(C) as FINRA Rule 4512(a)(1)(D), subject to certain amendments. *See* Exchange Act Release No. 63181 (October 26, 2010), 75 FR 67155 (November 1, 2010). Proposed FINRA Rule 4512(a)(1)(D) 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.

[13] *See* 31 CFR 103.122.

[14] *See* 31 CFR 103.19.

[15] *See, e.g.,* Exchange Act 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).

[16] FINRA is proposing to adopt NASD Rule 3110(c) as FINRA Rule 4512 (Customer Account Information), subject to certain amendments. *See* Exchange Act Release No. 63181 (October 26, 2010), 75 FR 67155 (November 1, 2010).

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 the member believes that the 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 the member is prepared to purchase or sell at that price and under the conditions stated at the time of the offer to buy or sell. Moreover, the use of fictitious transactions by a member or associated person to manipulate the market would also violate FINRA's rules regarding just and equitable principles of trade (FINRA Rule 2010) and fraud (FINRA Rule 2020).[17]

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. Section 11(a) of the Exchange Act and the rules thereunder also 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 proposed rule change.

B. Proposed FINRA Rule 2111

The proposed suitability obligation in 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 * * *."[18] This assessment would need to be "based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile[,]" which "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."[19]

The proposed rule would explicitly cover a recommended investment 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) estimates of 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 Interpretative Material ("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;[20] and
- Interactive investment materials that incorporate the above.[21]

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

- Reasonable basis (members must have reasonable grounds to believe, based on reasonable 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 transactions recommended to a customer within a certain period is not excessive).[22]

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,[23] and is exercising independent judgment in evaluating recommendations.[24] The proposal would require institutional customers to affirmatively indicate that they are exercising independent judgment,[25] and would harmonize the definition of institutional customer in the suitability rule with the definition of "institutional account" in NASD Rule 3110(c)(4).[26]

[17] *See, e.g., Terrance Yoshikawa,* Exchange Act Release No. 53731 (April 26, 2006), 87 SEC Docket 2924, 2006 SEC LEXIS 948 (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).

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

[19] *See* Proposed FINRA Rule 2111(a). FINRA modified various aspects of the proposed information-gathering requirements in response to comments.

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

[21] *See* Proposed FINRA Rule 2111.03. FINRA included this exception in response to comments.

[22] *See* Proposed FINRA Rule 2111.03.

[23] *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 NASD 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."

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

[25] *Id.* FINRA noted 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.

[26] *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*

Continued

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 these IMs would be unnecessary in light of the proposed changes to the scope of the suitability rule (*e.g.,* the proposed rule text would capture "strategies" currently referenced in IM–2310–3),[27] and others would be 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 Commission's penny stock rules,[28] while fraudulent conduct identified in IM–2310–2 is covered by Exchange Act and FINRA anti-fraud provisions [29]).

Other IM provisions would be incorporated in some form into the proposed rule or the supplementary material to the proposed rule. For example, the exemption in IM–2310–3 dealing with institutional customers has been modified and would be included in the text of proposed FINRA Rule 2111.[30] In addition, the explication of the three main suitability obligations in IM–2310–2 and IM–2310–3 has been consolidated into a single discussion in the proposed rule's supplementary material.[31] Similarly, the proposed rule's supplementary material would include a modified form of the current requirement in IM–2310–2 that a member refrain from recommending purchases beyond a customer's capability.[32] The supplementary material also would incorporate the discussions in IM–2310–2 and IM–2310–3 regarding the significance of the suitability rule in promoting fair dealing with customers and ethical sales practices.[33]

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).[34] Consequently, the elimination of the discussion of unauthorized trading in the IMs following the suitability rule does not alter 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 60 days following Commission approval. The implementation date will be no later than 270 days following publication of the Regulatory Notice announcing Commission approval.

III. Summary of Comments and FINRA's Response

As stated previously, the Commission received 22 comments in response to the proposed rule change,[35] and FINRA responded to the comments both by letter [36] and by filing an amendment to the proposed rule change to address certain comments.[37] Although commenters raised numerous suitability-related issues that FINRA previously addressed in its original rule filing with the Commission, a few commenters identified new suitability-related concerns regarding the proposed rule change, and some persuaded FINRA to amend the proposal. A discussion of those comments and FINRA's response follows.

Request for Indeterminate Delay of the Proposal

• Comments

Six commenters argued that FINRA's proposed rule changes should not be acted on until after policymakers (*e.g.,* Congress, the Commission, and/or FINRA) determine whether broker-dealers must comply with fiduciary obligations.[38] In particular, these commenters cited the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), which, among other things, requires the SEC to study the standards of care broker-dealers and investment advisers must adhere to when dealing with clients (including a fiduciary duty). These commenters advocated postponing FINRA's proposed rule changes until the parameters of any SEC rulemaking resulting from the study are clear. Other commenters strongly opposed any delay, citing the importance of FINRA's proposal to investor protection.[39]

• FINRA's Response

FINRA stated that its proposal generally maintains the core features of its current "know your customer" and suitability rules. FINRA also indicated that the proposed changes to those rules would provide greater protection to investors and greater certainty to broker-dealers by streamlining various provisions to focus on critical obligations that are not covered by other rules and by codifying in one place significant interpretations of key requirements.

FINRA also expressed the view that nothing in Dodd-Frank argues for the discontinuance of these important sales-practice obligations or the weakening of investor protection generally. FINRA stated that the suitability obligations in proposed Rule 2111 would not be inconsistent with a fiduciary duty if broker-dealers become subject to that duty at some future date.[40] In addition, FINRA noted that the suitability and "know your customer" standards are a material part of a fiduciary duty in the context of advice or recommendations.

In response to similar comments made with respect to FINRA's NTM 09–25, FINRA quoted a Commission release that noted "investment advisers under the Advisers Act" that 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." [41] FINRA also cited another Commission release that

Exchange Act Release No. 63181 (October 26, 2010), 75 FR 67155 (November 1, 2010).

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

[28] *See* Exchange Act Rule 15g–1 through 15g–9.

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

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

[31] *See* Proposed Rule 2111.05.

[32] *See* Proposed Rule 2111.06.

[33] *See* Proposed Rule 2111.01.

[34] *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 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).

[35] *See supra,* note 5.

[36] *See supra,* note 6.

[37] *See supra,* note 7.

[38] *See* TIAA–CREF Letter, CAI Letter, Schwab Letter, SIFMA Letter, TD Ameritrade Letter, and FSI Letter.

[39] *See* Black-Gross Letter.

[40] 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.

[41] 75 FR 51310, at 51314 (Aug. 19, 2010) and 75 FR 52562, 52567 (Aug. 26, 2010) citing SEC 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).

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."[42]

As to timing, FINRA maintained that improvements to investor protection and clarification of broker-dealer obligations should not be postponed indefinitely simply because there could potentially be a rule that may address similar issues at a future time. FINRA indicated that delay also would be problematic because it would amount to an open-ended postponement of the important benefits to customers and broker-dealers noted above. As some commenters noted, Dodd-Frank does not require that the Commission engage in rulemaking at the end of its study and, even if the Commission proposes a rule, there is no timetable for doing so.[43]

Proposed FINRA Rule 2090

• Comments

One commenter expressed concern regarding FINRA's proposed elimination of Supplementary Material .20 to NYSE Rule 405, which references the applicability of NYSE Rule 382 (Carrying Agreements) and the allocation of responsibility between introducing and carrying firms.[44]

• FINRA's Response

FINRA stated that because NASD Rule 3230 (Clearing Agreements), which generally would be applicable, similarly covers allocation issues between introducing and carrying firms, reference to NYSE Rule 382 is both outdated and unnecessary.

Proposed FINRA Rule 2111—Consistent Terminology and Expanded Explanation of Key Terms

• Comments

One commenter suggested that FINRA should maintain a standard approach to the terminology used in the rule.[45] The commenter gave as an example the use of "reasonable basis" in one section and "reasonable grounds" in another. The commenter also noted that the rule uses both "reasonable diligence" and "adequate due diligence." Another commenter asked FINRA to provide greater clarity in Supplementary Material regarding the terms "investment profile" and "reasonable diligence."[46]

• FINRA's Response

In response to this and other comments, FINRA filed Amendment No. 1, which amended the proposal to use more consistent terminology, where possible, and to provide more detailed explanations regarding key terms or responsibilities. As amended, the rule would consistently use the term "reasonable basis" rather than also using "reasonable grounds" and "reasonable expectations," and the term "reasonable diligence" instead of also using "due diligence" and "adequate diligence."[47] In addition, Amendment No. 1 amends the proposal to add expanded discussions regarding a "customer's investment profile" (see discussion below of new Supplementary Material .04—Customer's Investment Profile) and the "reasonable diligence" standards in the context of a customer's investment profile (see below) and reasonable-basis suitability.[48]

Proposed FINRA Rule 2111—Information Gathering

• Comments

Some commenters took issue with various aspects of the proposal's information-gathering requirements. Several commenters stated that obtaining each specified category of information is not warranted on every occasion.[49] Some asked that FINRA build flexibility into the rule so that a firm would not have to collect information if it was irrelevant based on the particular facts and circumstances.[50] Alternatively, these commenters requested that FINRA establish an effective date for the new rule that recognizes the difficulty associated with developing, modifying, and implementing forms and systems to request and capture the proposed new categories of information.[51]

One commenter maintained that factors such as a customer's investment experience, time horizon, and risk tolerance should be considered when reviewing a customer's portfolio as a whole, and not individual trades.[52] In this commenter's view, requiring consideration of such factors on a trade-by-trade basis would prevent customers from creating a diverse portfolio made up of securities with different levels of liquidity, risk, and time horizons.

• FINRA's Response

FINRA noted that the factors it added to the rule are subsets of broader categories of information identified in the current suitability rule, and that case law and regulatory notices have long stressed the significance of these factors to a suitability analysis. In response to those comments requesting flexibility regarding the type of information that firms must seek to obtain and comments requesting more guidance on what is required, FINRA proposed in Amendment No. 1 to add Supplementary Material .04 to FINRA Rule 2111.[53] FINRA believes proposed Supplementary Material .04 would provide flexibility regarding the type of information that firms must seek to obtain and analyze in connection with a recommendation under the proposed rule. However, because FINRA believes the factors discussed in Rule 2111(a) generally are relevant (and often crucial) to a suitability analysis, the proposed rule would require firms to document with specificity their reasonable basis for believing that a factor is not relevant in order to be relieved of the obligation

[42] 75 FR 51310, at 51314 (Aug. 19, 2010) and 75 FR 52562, 52567 (Aug. 26, 2010) citing Investment Advisers Act Release No. 1406, 1994 SEC LEXIS 797, at *4 (Mar. 16, 1994) (Suitability of Investment Advice Provided by Investment Advisers).

[43] *See* Black-Gross Letter.

[44] *See* SIFMA Letter.

[45] *See* SIFMA Letter.

[46] *Id.*

[47] *See, e.g.,* Proposed Rule 2090 (replacing the term "due diligence" with "reasonable diligence"); Supplementary Material .04 (Customer's Investment Profile) to Proposed Rule 2111 (using the terms "reasonable basis" and "reasonable diligence"); Supplementary Material .05 (Components of Suitability Obligations) to Proposed Rule 2111 (replacing the term "adequate due diligence" with the term "reasonable diligence" and replacing the term "reasonable grounds" with the term "reasonable basis"); Supplementary Material .06 (Customer's Financial Ability) to Proposed Rule 2111 (replacing the term "reasonable expectation" with the term "reasonable basis").

[48] The Supplementary Material regarding reasonable-basis suitability now contains the following expanded discussion of the term "reasonable diligence": "A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule."

[49] *See* Schwab Letter, CAI Letter, SIFMA Letter, TD Ameritrade Letter, and TIAA–CREF Letter.

[50] *See* CAI Letter, TD Ameritrade Letter, and TIAA–CREF Letter.

[51] *See* Schwab Letter, CAI Letter, SIFMA Letter, TD Ameritrade Letter, and TIAA–CREF Letter.

[52] *See* FSI Letter.

[53] Supplementary Material .04 to Proposed FINRA Rule 2111 would provide, "*.04 Customer's Investment Profile.* A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case."

to seek to obtain information about that factor.[54]

FINRA stated that proposed Supplementary Material .04 also led to the addition of new Supplementary Material .02 to proposed Rule 2111 that reiterates FINRA's longstanding position that firms and their associated persons cannot disclaim any obligations under the suitability rule.[55] Among other things, Supplementary Material .02 would clarify that firms and their associated persons cannot disclaim their obligation to use reasonable diligence to obtain and analyze relevant customer information.

Finally, FINRA indicated that it disagrees with the premise that a recommendation–by-recommendation analysis precludes consideration of a customer's investment portfolio. FINRA contended that although its suitability rule requires a recommendation-by-recommendation analysis, the current and proposed suitability rules explicitly permit the suitability analysis of a particular transaction to be performed within the context of the investor's other security holdings or investments. In fact, they requires that firms make reasonable efforts to gather and analyze information regarding a customer's other securities holdings as part of its suitability review.[56]

Proposed Rule 2111—Recommendations To Hold Securities

- Comments

Several commenters urged FINRA to clarify in the rule that the rule covers explicit recommendations to hold a security or securities.[57]

- FINRA's Response

FINRA indicated that it previously had stated that eliminating in the proposed rule the reference to "purchase, sale or exchange" used in the current rule and adding in the proposed rule the term "strategy" meant that the proposed rule would cover explicit recommendations to hold a security or securities.[58] FINRA explained that 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.[59]

For purposes of clarity, Amendment No. 1 would amend Supplementary Material .03 to state that investment strategies would include, among other things, an explicit recommendation to hold a security or securities.

Proposed Rule 2111—Institutional Customers

- Comments

One commenter requested that FINRA exempt from the "affirmative indication" requirement of proposed Rule 2111(b) those institutional investors that qualify as qualified institutional buyers ("QIBs") for purposes of Rule 144A under the Securities Act of 1933 (the "Securities Act").[60] That commenter argued that "[QIBs] are among the most sophisticated counterparties in the institutional marketplace, and member firms already have well established suitability procedures for these customers that reflect their level of sophistication."

The same commenter also suggested that FINRA expand the coverage of proposed Rule 2111(b) so that, in addition to meeting its customer-specific suitability obligation, a member firm also meets its quantitative suitability obligation if the conditions in Rule 2111(b)(1) and (2) are satisfied.[61] That commenter stated that imposing a quantitative suitability obligation in the institutional delivery-versus-payment/receipt-versus-payment context makes little sense. The commenter also stated that, because business institutions typically have their own internal portfolio managers, handle custody away from the broker-dealer and execute trades with multiple firms, no single broker-dealer would see all of an institution's trades or its entire investment portfolio, and thus no single broker-dealer would be in a position to determine whether the institution's transactions are so excessive or frequent as to constitute churning.

In addition, this commenter requested that FINRA modify the sentence in proposed Supplementary Material .05 providing that "[w]ith respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, 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."[62] The commenter believed this sentence was confusing and subject to varying interpretations. The commenter stated that it believed that "the intent of Supplementary Material .05 is to clarify that proposed Rule 2111(b)(2) allows member firms to establish and document a clear understanding of the institutional customer's independence at the outset of the relationship—that is, at the time of account opening," and that if the intent were not as it believed, the sentence would "fundamentally alter the operation of the institutional markets and could have a negative impact on execution quality."

- FINRA's Response

FINRA stated, with respect to the comment that FINRA should exempt firms from the requirement to obtain an "affirmative indication" from QIBs, that it does not believe that a monetary threshold, whatever the amount or context, is an adequate substitute for the proposed requirement that the institutional customer affirmatively acknowledge that it is exercising independent judgment as part of the determination that an exemption from customer-specific suitability applies.

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[54] FINRA noted that the efforts of a firm that seeks but does not obtain information about a particular factor (as opposed to a situation where the firm does not attempt to obtain the information about a particular factor) would be judged by the "reasonable diligence" standard. FINRA also noted that, when customer information is unavailable despite a firm's reasonable diligence in seeking to obtain the information, the firm must carefully consider whether it has sufficient customer information to properly evaluate the suitability of a recommendation to the customer. However, FINRA noted further that if the firm used reasonable diligence, the absence of some customer information that is not critical to the analysis based on the facts and circumstances of the particular situation generally would not preclude a recommendation from being viewed as suitable as long as the broker had obtained and analyzed other customer information that provided the broker with a reasonable basis to believe that the recommendation was suitable for that customer. FINRA Response, note 19.

[55] *See e.g., Notice to Members* 01–23 (Apr., 2001) ("[A] broker-dealer cannot disclaim away its suitability obligations * * *.") Supplementary Material .02 to Proposed FINRA Rule 2111 reads "*.02 Disclaimers.* A member or associated person cannot disclaim any responsibilities under the suitability rule."

[56] This statement was confirmed in a telephone conversation between James Wrona, Associate Vice President and Associate General Counsel, FINRA, and Bonnie Gauch, Special Counsel, Division of Trading and Markets, Commission, on November 15, 2010.

[57] *See* Brewer Letter, Catalano Letter, Estell Letter, Ilgenfritz Letter, Jacobson Letter, Krosschell Letter, Layne Letter, Mougey Letter, Neuman Letter, PIABA Letter, and Van Kampen Letter.

[58] Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 51310, at 51316 (Aug. 19, 2010) and Exchange Act Release No. 62718A (Aug. 20, 2010), 75 FR 52562, at 52568 (Aug. 26, 2010) ("The term "strategy," moreover, would cover explicit recommendations to hold a security or securities.") FINRA further stated that the rule would not cover implicit recommendations to hold a security or securities.

[59] *Id.*

[60] *See* SIFMA Letter. Rule 144A deals with the application of Section 5 of the Securities Act to private resales of securities to institutions. It does not limit the application of the antifraud or other provisions of the federal securities laws.

[61] *See* SIFMA Letter.

[62] *Id.*

With respect to the comment that FINRA should expand proposed Rule 2111(b) to provide that a member firm meets both its customer specific obligation and its quantitative suitability obligation if it satisfies the conditions in Rule 2111(b)(1) and (2), FINRA stated that it is important that a firm not recommend an unsuitable number of transactions in those circumstances where it has control over an account. FINRA emphasized, however, that quantitative suitability generally would apply only with regard to that portion of an institutional customer's portfolio that the firm controls and only with regard to the firm's recommended transactions.

Finally, with respect to the request for clarification of the sentence in Supplementary Material .05, FINRA stated that its intent was to allow an institutional investor to 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," and that it believes the language of the Supplementary Material is clear. Further, FINRA indicated that if a broker-dealer believes that such action on a trade-by-trade basis would fundamentally change its operations, it can decide as a business matter to service only those institutional investors that are willing to make the affirmative indication in terms of all potential transactions for its account.

IV. Discussion and Commission Findings

After careful review of the proposed rule change, the comments received, and FINRA's response to the comments, the Commission finds that the proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to a national securities association.[63] The Commission believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act[64] in that it is designed to prevent fraudulent or manipulative acts and practices, promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Specifically, the Commission believes the proposed rule change is consistent with FINRA's obligations under the Exchange Act to prevent fraudulent or manipulative acts and practices, and to promote just and equitable principles of trade, because the proposed rule would incorporate the NASD suitability rule and the NYSE "know your customer" rule into the FINRA consolidated rulebook. The suitability and "know your customer" obligations are critical to ensuring investor protection and fair dealing with customers. The proposed rule changes also would modify those rules to strengthen and clarify them, and incorporate into the rules certain settled interpretive guidance and case law.

Additionally, the Commission believes that FINRA has adequately responded to commenters' concerns both by its letter of October 21, 2010 and its filing of Amendment No. 1. Amendment No. 1 would standardize the terminology used in the proposed rule change, provide additional clarification with respect to certain aspects of the proposed rule change, and provide broker-dealers with appropriate flexibility without impairing the rules' investor protection goals.

V. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Exchange Act,[65] for approving the proposed rule change, as modified by Amendment No. 1, prior to the 30th day after publication of Amendment No. 1 in the Federal Register. The changes proposed in Amendment No. 1 respond to specific concerns raised by commenters and do not raise any additional issues. In particular, Amendment No. 1 would standardize the terminology used in the proposed rule change, provide additional clarification with respect to certain aspects of the proposed rule change, and provide broker-dealers with appropriate flexibility without impairing the rule's investor protection goals.

Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Amendment No.1, on an accelerated basis.

VI. 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 December 14, 2010.

VII. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[66] that the proposed rule change (SR–FINRA–2008–039), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[67]

Florence E. Harmon,

Deputy Secretary.

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[63] In approving this proposal, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 17c(f).

[64] 15 U.S.C. 78*o*–3(b)(6).

[65] 15 U.S.C. 78s(b)(2).

[66] *Id.*

[67] 17 CFR 200.30–3(a)(12).