

Finra takes foot off suitability pedal

Regulator backtracks from earlier, broader rule interpretation

By Dan Jamieson

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The Financial Industry Regulatory Authority Inc. has eased up on a controversial interpretation of its new suitability rule in a move that is bound to make the industry happy.



In new guidance issued Monday, Finra backtracked from an earlier, expansive interpretation of the rule, which held that people who were not customers, and investment strategies that did not involve securities, were covered under the suitability rule.

But in Regulatory Notice 12-55, Finra now says the rule applies only to customers who open an account or buy a product for which the brokerage firm receives compensation.

In addition, the new notice says the suitability rule does not apply to recommendations of non-security products made as part of an individual broker's outside business activity.

However, a firm's "suitability analysis also must be informed by a general understanding of the non-security component of the recommended investment strategy," Finra said in the notice.

Independent registered representatives often sell insurance and engage in investment advisory activities outside of their broker-dealers, which brokerage firms must approve of and track under Finra's outside-business-activity rules.

Finra also clarified that its new suitability rule would generally not create a continuing duty to monitor an investment or strategy.

The new guidance was welcomed by industry lawyers, who have complained that the earlier guidance, issued in May, caught the industry by surprise.

"Finra should be praised for listening to its member firms and reps," said Brian Rubin, a partner at Sutherland Asbill & Brennan LLP.

“Under the new guidance, now reps don't have to fear that if they speak with people who aren't customers, such as engaging in idle chat during upcoming holiday parties, they will be charged under the suitability rule,” he said.

“Of course, it would have been better if Finra had listened to [the industry] earlier before firms spent a lot of time, energy and money to try to figure what to do with [the] prior guidance,” Mr. Rubin added.

The new notice is “a helpful clarification on the definition of customer,” said Hardy Callcott, a partner at Bingham McCutchen LLP, “and it gives firms more guidance ... on when the suitability obligation applies to a mixed securities/non-securities transaction.”

In an e-mail, Finra spokeswoman Nancy Condon wrote that the self-regulator wanted to clarify “issues relating to who is considered a 'customer' and provide greater detail on what investment strategies are covered.”

But Marc Menchel, principal at Menchel Consulting LLC, and until last June the former general counsel for regulation at Finra, questioned why the guidance treats customers and potential customers differently.

“I don't think it's internally consistent,” he said.

And although Finra now says brokers don't have a suitability obligation to someone who never becomes a customer, the notice also warns that a broker's recommendation to a potential investor could violate Finra's far-reaching standard of “just and equitable principals of trade” under Rule 2010, Mr. Menchel said.

The suitability rule went into effect in July after being approved last year by the Securities and Exchange Commission.