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FINRA Reverses Course and Issues Guidance Changing Its Interpretation Regarding the Key Issues of “Potential Investors” and Non-Security Recommendations

Background

FINRA's new suitability requirement, Rule 2111, went into effect July 9, 2012. Because the rule was such a departure from prior standards, FINRA issued Regulatory Notice 12-25 (May 2012) to explain the rule and to clarify its implications. In an unusual regulatory do-over, on December 10, 2012, less than six months after the effective date of the rule, FINRA issued Regulatory Notice 12-55 (December 2012) changing its interpretation regarding certain key issues. View the full [RN 12-55](#).

“Potential Investors” (Also Known as Non-Customers)

FINRA's new suitability rule does not explicitly address the issue of suitability obligations to non-customers, which FINRA calls “potential investors.” In Question 6 to its Regulatory Notice 12-25, FINRA raised quite a few eyebrows when it noted that a broker-dealer's suitability obligations may extend to “an individual or entity with whom a broker dealer has even an informal business relationship...(such as) when a broker recommends a security to a *potential* investor, even if that potential investor does not have an account at the firm.” (emphasis in original) This language led some to conclude that suitability obligations could apply even to informal recommendations made at a social gathering, such as a holiday party. In RN 12-55, FINRA withdrew Question 6 issued in May and instead substituted a new Question and Answer 6(b). This clarification appears to resolve the issue of when the suitability rule applies to informal investment advice provided by an associated person in a non-traditional setting. According to RN 12-55, “the suitability rule would not apply to the recommendation....if the potential investor does not act on the recommendation or executes the recommended transaction away from the broker-dealer with which the registered person is associated without the broker-dealer receiving compensation for the transaction.”

If the potential investor, in fact, establishes an account and acts on the recommendation (and thus becomes a “customer”), the suitability of the recommendation is evaluated based upon the circumstances that existed at the time the recommendation was made, and the suitability obligation is triggered after the account is opened and the transaction occurs.

Non-Securities

FINRA also withdrew Question 10 from RN 12-25, which dealt with suitability obligations that attach to a recommendation to purchase or sell a non-security product. Under newly substituted Question 10, suitability obligations apply only if there is a security and non-security component to the transaction. For example, if a registered person simply recommends that a customer open a home equity loan or draw down credit on that loan, there is no suitability concern. If, however, the recommendation is to draw down on home equity credit and purchase stocks, then the suitability analysis applies to both the non-security recommendation (liquefy home equity) and the security transaction (buy stocks).

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The footnotes to RN 12-55 make clear that the guidance applies only to a broker-dealer's suitability obligations and is not intended to limit a broker's obligations under related rules, including, but not limited to, selling away or private securities transactions.



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