

Required fields are shown with yellow backgrounds and asterisks.

Page 1 of * <input type="text" value="94"/>	SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Form 19b-4	File No.* SR - <input type="text" value="2020"/> - * <input type="text" value="007"/>	Amendment No. (req. for Amendments *) <input type="text"/>
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Filing by Financial Industry Regulatory Authority
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * <input checked="" type="checkbox"/>	Amendment * <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) * <input checked="" type="checkbox"/>	Section 19(b)(3)(A) * <input type="checkbox"/>	Section 19(b)(3)(B) * <input type="checkbox"/>
			Rule		
Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action * <input type="checkbox"/>	Date Expires * <input type="text"/>	<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	<input type="checkbox"/> 19b-4(f)(6)
			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010	Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934
Section 806(e)(1) * <input type="checkbox"/>	Section 806(e)(2) * <input type="checkbox"/>
Section 3C(b)(2) * <input type="checkbox"/>	

Exhibit 2 Sent As Paper Document <input type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>
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Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to FINRA's Suitability, Non-Cash Compensation and Capital Acquisition Broker (CAB) Rules in Response to Regulation Best Interest

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * <input type="text" value="Joseph"/>	Last Name * <input type="text" value="Savage"/>
Title * <input type="text" value="Vice President, OGC Regulatory Analysis"/>	
E-mail * <input type="text" value="joe.savage@finra.org"/>	
Telephone * <input type="text" value="(240) 386-4534"/>	Fax <input type="text" value="(301) 216-3720"/>

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

(Title *)

Date <input type="text" value="03/12/2020"/>	<input type="text" value="Senior Vice President and Deputy General Counsel"/>
By <input type="text" value="Patrice Gliniecki"/>	<input type="text" value="Patrice Gliniecki"/>

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFF website.

Form 19b-4 Information *

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change *

Add Remove View

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies *

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit Sent As Paper Document

Exhibit 3 - Form, Report, or Questionnaire

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit Sent As Paper Document

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act,” or “Exchange Act”),¹ Financial Industry Regulatory Authority, Inc. (“FINRA”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) proposed amendments to FINRA Rules 2111 (Suitability), 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements), and Capital Acquisition Broker (CAB) Rule 211 (Suitability). The proposed rule change would: (1) amend the FINRA and CAB suitability rules to state that the rules do not apply to recommendations subject to Regulation Best Interest (“Reg BI”),² and to remove the element of control from the quantitative suitability obligation; and (2) conform the rules governing non-cash compensation to Reg BI’s limitations on sales contests, sales quotas, bonuses and non-cash compensation.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The FINRA Board of Governors has authorized the filing of the proposed rule change with the SEC; no other action by FINRA is necessary for the filing of the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.15l-1.

If the Commission approves the proposed rule change, FINRA will announce the approval of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be the compliance date of Reg BI.

3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

On June 5, 2019, the SEC adopted Reg BI, a new rule under the Exchange Act, which establishes a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as “broker-dealer”) when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities.³ The SEC stated that Reg BI will improve investor protection by enhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer, and reducing the potential harm to retail customers from conflicts of interest that may affect the recommendation.⁴ The date by which broker-dealers must comply with Reg BI is June 30, 2020.⁵

FINRA proposes to amend the suitability and non-cash compensation rules to provide clarity on which standard applies and to address inconsistencies with Reg BI.

³ See Securities Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019) (Final Rule; Regulation Best Interest: The Broker-Dealer Standard of Conduct) (the “Release”).

⁴ See Release, 84 FR at 33318-33319.

⁵ See Release, 84 FR at 33400.

The changes would amend the FINRA suitability rule (Rule 2111) to state that it will not apply to recommendations subject to Reg BI, and to remove the element of control from the quantitative suitability obligation. In addition, the proposed rule change would conform the CAB suitability rule, CAB Rule 211, to the proposed amendments to Rule 2111, and would conform FINRA's rules governing non-cash compensation to Reg BI's limitations on sales contests, sales quotas, bonuses, and non-cash compensation.

As noted below, Reg BI addresses the same conduct that is addressed by Rule 2111, but employs a best interest, rather than a suitability, standard. Absent action by FINRA, a broker-dealer would be required to comply with both Reg BI and Rule 2111 regarding recommendations to retail customers. In such circumstances, FINRA believes that compliance with Reg BI would result in compliance with Rule 2111 because a broker-dealer that meets the best interest standard would necessarily meet the suitability standard. Accordingly, in order to reduce the potential for confusion, FINRA is proposing limiting the application of Rule 2111 to circumstances in which Reg BI does not apply. To do so, FINRA would add new paragraph .08 to the FINRA Rule 2111 Supplementary Material and new paragraph .03 to the CAB Rule 211 Supplementary Material that states that those rules shall not apply to recommendations subject to Reg BI.

Suitability

FINRA Rule 2111 requires that a broker-dealer "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 further explains 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."⁶

Rule 2111 imposes three main suitability obligations: reasonable basis suitability, customer-specific suitability and quantitative suitability. Reasonable basis suitability requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Customer-specific suitability requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.⁷

Rule 2111(b) provides an exemption to customer-specific suitability for recommendations to institutional customers under specified circumstances. In order for this exemption to apply, three criteria must be satisfied. First, the account must meet the definition of institutional account as defined in FINRA Rule 4512(c).⁸ Second, the

⁶ See FINRA Rule 2111(a).

⁷ See FINRA Rule 2111.05.

⁸ Rule 4512(c) defines "institutional account" to mean the account of: (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC or with a state

broker-dealer must 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 involving a security or securities. Third, the institutional customer must affirmatively indicate that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision making authority to an agent, such as an investment adviser or a bank trust department, these factors are applied to the agent.⁹

Reg BI's "best interest" standard requires firms to satisfy four component obligations: Disclosure, Care, Conflict of Interest and Compliance. Reg BI's Care Obligation incorporates and enhances principles that are also found in Rule 2111. Two key enhancements are that Reg BI explicitly imposes a best interest standard and explicitly requires a consideration of costs. In addition, Reg BI places greater emphasis than the suitability rule on consideration of reasonably available alternatives.¹⁰ Moreover, Reg BI explicitly applies to recommendations of types of accounts (e.g., broker-dealer or investment adviser, or among broker-dealer accounts, including

securities commission; or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

⁹ See FINRA Rule 2111(b).

¹⁰ See Release, 84 FR at 33381 ("It is our view that such a consideration [of reasonably available alternatives offered by the broker-dealer] is an inherent aspect of making a 'best interest' recommendation, and is a key enhancement over existing broker-dealer suitability obligations, which do not necessarily require such a comparative assessment among such alternatives").

recommendations of IRA rollovers). Reg BI also eliminates the “control” element of the quantitative suitability obligation.

In light of these enhancements and to provide clarity on which standard applies, FINRA proposes that its suitability rule state that it will not apply to recommendations subject to Reg BI.¹¹ FINRA does not propose to eliminate the suitability rule because it applies broadly to all recommendations to customers whereas Reg BI applies only to recommendations to “retail customers,” which Reg BI defines as a natural person, or the legal representative of such natural person, who receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer and uses the recommendation primarily for personal, family, or household purposes.¹² Thus, FINRA’s suitability rule is still needed for entities and institutions (e.g., pension funds), and natural persons who will not use recommendations primarily for personal, family, or household purposes (e.g., small business owners and charitable trusts).

In addition, the proposal would modify the quantitative suitability obligation under FINRA Rule 2111.05(c) to remove the element of control that currently must be proved to demonstrate a violation.¹³ This change is consistent with Reg BI, which eliminates the control element from its Care obligation.

Finally, the proposed rule change would amend CAB Rule 211 to state that it will not apply to recommendations subject to Reg BI.¹⁴

¹¹ See proposed FINRA Rule 2111.08.

¹² See 17 CFR 240.151-1(b)(1).

¹³ See proposed FINRA Rule 2111.05(c).

¹⁴ See proposed CAB Rule 211.03.

Non-Cash Compensation

FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) each includes provisions restricting the payment and receipt of non-cash compensation in connection with the sale and distribution of securities governed by those rules. As a general matter, these rules limit non-cash compensation arrangements to:

- Gifts that do not exceed \$100 in value and that are not preconditioned on the achievement of a sales target;
- An occasional meal, a ticket to a sporting event or the theater, or other comparable entertainment that does not raise any question of propriety and is not preconditioned on the achievement of a sales target;
- Payment or receipt by “offerors” (generally product sponsors and their affiliates) in connection with training or education meetings, subject to specified conditions, including that the payment of such compensation is not conditioned on achieving a sales target; and
- Internal non-cash compensation arrangements between a member and its associated persons, subject to specified conditions. If the internal non-cash compensation arrangement is in the form of a sales contest, the contest must be based on the total production of associated persons with

respect to all securities within the rule's product category, and credit for those sales must be equally weighted.¹⁵

Reg BI's Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time period.¹⁶ As discussed above, FINRA's current non-cash compensation rules permit internal firm sales contests that may not meet this standard, since they permit contests based on sales of specific types of securities (such as mutual funds or variable annuities).

FINRA proposes to modify its rules governing non-cash compensation arrangements to specify that any non-cash compensation arrangement permitted by those rules must be consistent with the requirements of Reg BI. FINRA also proposes to eliminate provisions in Rules 2320 and 2341 that require internal non-cash compensation arrangements to be based on total production and equal weighting of securities sales.¹⁷ Thus, firms generally would no longer be permitted to sponsor or maintain internal sales contests based on sales of securities within a product category within a limited time, even if they are based on total production and equal weighting. This requirement also would apply to the non-cash compensation provisions governing gifts, business entertainment

¹⁵ See FINRA Rules 2310(c), 2320(g), 2341(l)(5), and 5110(h). Rules 2310(c) and 5110(h) do not require internal non-cash compensation arrangements to be based on total production and equal weighting of securities sales.

¹⁶ See 17 CFR 240.151-1(a)(2)(iii)(D).

¹⁷ See proposed amendments to FINRA Rules 2310(c), 2320(g), 2341(l)(5), and 5110(h).

and training or education meetings. As discussed above, these forms of non-cash compensation may not be preconditioned on achievement of a sales target. Nevertheless, FINRA believes that it must make clear that these provisions do not permit arrangements that conflict with Reg BI.

If the Commission approves the proposed rule change, FINRA will announce the approval of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be the compliance date of Reg BI.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁸ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed changes to FINRA's suitability rules will clarify when Reg BI versus the suitability rules apply, eliminating confusion and allowing firms to focus on compliance with the higher standards in Reg BI, when applicable. At the same time, the change will provide continued protection for customers that are not retail customers covered by Reg BI. Moreover, the removal of the element of control from the quantitative suitability obligation will align this standard with the corresponding quantitative component of the Care Obligation under Reg BI. Finally, the proposed amendments to FINRA's rules on non-cash compensation arrangements will eliminate any potential inconsistency with the requirements of Reg BI.

¹⁸ 15 U.S.C. 78q-3(b)(6).

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rulemaking, its potential economic impacts, including anticipated costs and benefits, and the alternatives FINRA considered in assessing how to best meet its regulatory objectives.

Economic Impact Assessment

Reg BI imposes new obligations on broker-dealers and associated persons. As such, FINRA is proposing to modify existing FINRA rules to better align them with the new obligations. The alignment of FINRA rules to Reg BI requirements is expected to provide greater protections to customers against investor abuse from firms and their associated persons. It also reduces uncertainty for firms about which standard applies, thus potentially avoiding unintentional rule violations and reducing compliance costs on the margin. The Economic Impact Assessment analyzes only the impacts directly attributable to the proposed rule change. The impacts attributable to Reg BI are assumed to have been evaluated by the SEC during the adoption process.

The proposed rule changes would better align the existing FINRA suitability rule with Reg BI's obligations. The proposed rule change would provide that the suitability rule does not apply to any recommendation that is subject to Reg BI. The benefits of this approach are that it would reduce regulatory uncertainty for firms and clarify to retail customers that Reg BI's "best interest" standard applies to recommendations they receive from their broker-dealer and its associated persons. FINRA does not believe that this

change will negatively impact firms in any material way, since in almost all cases, retail customer recommendations would be governed by Reg BI, making the application of the suitability rule in these contexts superfluous. Firms also would benefit by focusing their regulatory review of recommendations to retail customers solely on Reg BI, thus increasing the efficiency of such reviews.

The proposed rule change also would eliminate the control element from the quantitative suitability obligation in the suitability rule. This change is consistent with Reg BI, which similarly does not require a showing of control. FINRA had previously analyzed the economic impact of this change when it proposed it in Regulatory Notice 18-13. Potential economic impacts are even less significant at this time, as the SEC has since adopted Reg BI, which expressly excludes the control element and will now apply to a large portion of recommendations (i.e., recommendations to retail customers).

The proposed change is expected to provide greater protections to customers against investor abuse from firms and their associated persons. In cases where excessive trading is alleged, customers would benefit from the reduced burden on FINRA of not having to prove control while firms and associated persons engaged in excessive trading could experience a higher number of findings of violations. FINRA believes the proposed change would impose minimal, if any, additional compliance burdens on members because FINRA staff understands firms generally perform compliance reviews for excessive trading activity without consideration of whether a broker controls the account.

Lastly, the proposed rule change would align FINRA's non-cash compensation rules with Reg BI's Conflict of Interest Obligation. Reg BI requires broker-dealers to

establish, maintain and enforce written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time period, whereas current FINRA non-cash compensation rules permit sales contests for specific types of securities. FINRA believes that this proposed rule change will benefit firms by eliminating regulatory uncertainty created by existing FINRA non-cash compensation rules. To the extent that sales contests and other non-cash compensation arrangements lead brokers to recommend suboptimal investments for customers, banning these practices may benefit customers. However, as for-profit entities, firms may be more limited in their ability to create incentives for their brokers to generate sales.

5. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Comments were neither solicited nor received on this proposed rule change.

However, in April 2018, FINRA published Regulatory Notice 18-13, soliciting comment on a proposal to remove the control element from the quantitative suitability obligation in FINRA Rule 2111, consistent with the then-proposed Reg BI. Eleven comments were received in response to the Notice. A copy of the Notice is attached as Exhibit 2a.

Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.¹⁹

Since the publication of Regulatory Notice 18-13, the SEC has adopted Reg BI, which applies to recommendations to retail customers as defined in Reg BI. With the

¹⁹ See Exhibit 2b for a list of abbreviations assigned to commenters.

proposed changes to FINRA Rule 2111.08, as discussed above, the suitability rule, including the quantitative suitability obligation, will no longer apply to recommendations to retail customers. As a result, the impact of the removal of the control element of the quantitative suitability obligation is significantly less than when originally proposed. Nevertheless, a majority of commenters to Regulatory Notice 18-13 indicated general support for the proposal to remove the control element from the quantitative suitability obligation of FINRA Rule 2111.²⁰ In general, these commenters expressed that the proposed rule change was a reasonable and effective approach to improving the rule,²¹ and believe it would heighten investor protection.²² Some commenters raised questions with particular aspects of the proposal or potential unintended consequences.²³ Several commenters were not supportive and raised concerns with the proposal.²⁴ Many of the comments have been rendered moot by the SEC's adoption of Reg BI or the concerns raised have become less relevant given that Reg BI is now the governing standard that applies to recommendations to retail customers. For example, while some commenters supported FINRA's proposal to remove the control element from the quantitative suitability obligation because it was consistent with the approach set forth in the proposed

²⁰ See Cornell; FSI; NASAA; Pace; PIABA; SEC OIA.

²¹ See NASAA.

²² See Cornell; FSI; NASAA; Pace; PIABA.

²³ See FSI; PIABA; SER.

²⁴ See Cambridge; Capital Forensics; Keesal; SIFMA.

Reg BI,²⁵ several commenters indicated that FINRA's proposal was premature and that FINRA should await the outcome of the SEC's proposed rulemaking.²⁶ FINRA did hold off in filing with the Commission the rule change proposed in Regulatory Notice 18-13. With the final adoption of Reg BI, however, the time is ripe to finalize this change. As a result, for recommendations that remain subject to FINRA Rule 2111 (i.e., recommendations that are not covered by Reg BI), this aspect of the proposed rule change will enable FINRA to more effectively address instances of excessive trading by removing the element of control that currently must be proved to demonstrate a violation and will align this integral element of FINRA's suitability rule with corresponding provision of Reg BI.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in section 19(b)(2) of the Act.²⁷

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

²⁵ See FSI.

²⁶ See Cambridge; Keesal; SIFMA.

²⁷ 15 U.S.C. 78s(b)(2).

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 18-13 (April 2018).

Exhibit 2b. List of commenters.

Exhibit 2c. Comment letters received in response to Regulatory Notice 18-13 (April 2018).

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2020-007)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to FINRA’s Suitability, Non-Cash Compensation and Capital Acquisition Broker (CAB) Rules in Response to Regulation Best Interest

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing amendments to FINRA Rules 2111 (Suitability), 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements), and Capital Acquisition Broker (CAB) Rule 211 (Suitability). The proposed rule change would: (1) amend the FINRA and CAB suitability rules to state that the rules do not apply to recommendations subject to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Regulation Best Interest (“Reg BI”),³ and to remove the element of control from the quantitative suitability obligation; and (2) conform the rules governing non-cash compensation to Reg BI’s limitations on sales contests, sales quotas, bonuses and non-cash compensation.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

On June 5, 2019, the SEC adopted Reg BI, a new rule under the Exchange Act, which establishes a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as “broker-dealer”) when they make a recommendation to a retail customer of any securities

³ 17 CFR 240.15l-1.

transaction or investment strategy involving securities.⁴ The SEC stated that Reg BI will improve investor protection by enhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer, and reducing the potential harm to retail customers from conflicts of interest that may affect the recommendation.⁵ The date by which broker-dealers must comply with Reg BI is June 30, 2020.⁶

FINRA proposes to amend the suitability and non-cash compensation rules to provide clarity on which standard applies and to address inconsistencies with Reg BI. The changes would amend the FINRA suitability rule (Rule 2111) to state that it will not apply to recommendations subject to Reg BI, and to remove the element of control from the quantitative suitability obligation. In addition, the proposed rule change would conform the CAB suitability rule, CAB Rule 211, to the proposed amendments to Rule 2111, and would conform FINRA's rules governing non-cash compensation to Reg BI's limitations on sales contests, sales quotas, bonuses, and non-cash compensation.

As noted below, Reg BI addresses the same conduct that is addressed by Rule 2111, but employs a best interest, rather than a suitability, standard. Absent action by FINRA, a broker-dealer would be required to comply with both Reg BI and Rule 2111 regarding recommendations to retail customers. In such circumstances, FINRA believes that compliance with Reg BI would result in compliance with Rule 2111 because a broker-dealer that meets the best interest standard would necessarily meet the suitability

⁴ See Securities Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019) (Final Rule; Regulation Best Interest: The Broker-Dealer Standard of Conduct) (the "Release").

⁵ See Release, 84 FR at 33318-33319.

⁶ See Release, 84 FR at 33400.

standard. Accordingly, in order to reduce the potential for confusion, FINRA is proposing limiting the application of Rule 2111 to circumstances in which Reg BI does not apply. To do so, FINRA would add new paragraph .08 to the FINRA Rule 2111 Supplementary Material and new paragraph .03 to the CAB Rule 211 Supplementary Material that states that those rules shall not apply to recommendations subject to Reg BI.

Suitability

FINRA Rule 2111 requires that a broker-dealer “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 further explains 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.”⁷

Rule 2111 imposes three main suitability obligations: reasonable basis suitability, customer-specific suitability and quantitative suitability. Reasonable basis suitability requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Customer-specific suitability requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer’s investment profile. Quantitative suitability requires a member

⁷ See FINRA Rule 2111(a).

or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.⁸

Rule 2111(b) provides an exemption to customer-specific suitability for recommendations to institutional customers under specified circumstances. In order for this exemption to apply, three criteria must be satisfied. First, the account must meet the definition of institutional account as defined in FINRA Rule 4512(c).⁹ Second, the broker-dealer must 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 involving a security or securities. Third, the institutional customer must affirmatively indicate that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision making authority to an agent, such as an investment adviser or a bank trust department, these factors are applied to the agent.¹⁰

Reg BI's "best interest" standard requires firms to satisfy four component obligations: Disclosure, Care, Conflict of Interest and Compliance. Reg BI's Care

⁸ See FINRA Rule 2111.05.

⁹ Rule 4512(c) defines "institutional account" to mean the account of: (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC or with a state securities commission; or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

¹⁰ See FINRA Rule 2111(b).

Obligation incorporates and enhances principles that are also found in Rule 2111. Two key enhancements are that Reg BI explicitly imposes a best interest standard and explicitly requires a consideration of costs. In addition, Reg BI places greater emphasis than the suitability rule on consideration of reasonably available alternatives.¹¹ Moreover, Reg BI explicitly applies to recommendations of types of accounts (e.g., broker-dealer or investment adviser, or among broker-dealer accounts, including recommendations of IRA rollovers). Reg BI also eliminates the “control” element of the quantitative suitability obligation.

In light of these enhancements and to provide clarity on which standard applies, FINRA proposes that its suitability rule state that it will not apply to recommendations subject to Reg BI.¹² FINRA does not propose to eliminate the suitability rule because it applies broadly to all recommendations to customers whereas Reg BI applies only to recommendations to “retail customers,” which Reg BI defines as a natural person, or the legal representative of such natural person, who receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer and uses the recommendation primarily for personal, family, or household purposes.¹³ Thus, FINRA’s suitability rule is still needed for entities and institutions (e.g., pension funds),

¹¹ See Release, 84 FR at 33381 (“It is our view that such a consideration [of reasonably available alternatives offered by the broker-dealer] is an inherent aspect of making a ‘best interest’ recommendation, and is a key enhancement over existing broker-dealer suitability obligations, which do not necessarily require such a comparative assessment among such alternatives”).

¹² See proposed FINRA Rule 2111.08.

¹³ See 17 CFR 240.151-1(b)(1).

and natural persons who will not use recommendations primarily for personal, family, or household purposes (e.g., small business owners and charitable trusts).

In addition, the proposal would modify the quantitative suitability obligation under FINRA Rule 2111.05(c) to remove the element of control that currently must be proved to demonstrate a violation.¹⁴ This change is consistent with Reg BI, which eliminates the control element from its Care obligation.

Finally, the proposed rule change would amend CAB Rule 211 to state that it will not apply to recommendations subject to Reg BI.¹⁵

Non-Cash Compensation

FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), and 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) each includes provisions restricting the payment and receipt of non-cash compensation in connection with the sale and distribution of securities governed by those rules. As a general matter, these rules limit non-cash compensation arrangements to:

- Gifts that do not exceed \$100 in value and that are not preconditioned on the achievement of a sales target;
- An occasional meal, a ticket to a sporting event or the theater, or other comparable entertainment that does not raise any question of propriety and is not preconditioned on the achievement of a sales target;

¹⁴ See proposed FINRA Rule 2111.05(c).

¹⁵ See proposed CAB Rule 211.03.

- Payment or receipt by “offerors” (generally product sponsors and their affiliates) in connection with training or education meetings, subject to specified conditions, including that the payment of such compensation is not conditioned on achieving a sales target; and
- Internal non-cash compensation arrangements between a member and its associated persons, subject to specified conditions. If the internal non-cash compensation arrangement is in the form of a sales contest, the contest must be based on the total production of associated persons with respect to all securities within the rule’s product category, and credit for those sales must be equally weighted.¹⁶

Reg BI’s Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time period.¹⁷ As discussed above, FINRA’s current non-cash compensation rules permit internal firm sales contests that may not meet this standard, since they permit contests based on sales of specific types of securities (such as mutual funds or variable annuities).

FINRA proposes to modify its rules governing non-cash compensation arrangements to specify that any non-cash compensation arrangement permitted by those rules must be consistent with the requirements of Reg BI. FINRA also proposes to

¹⁶ See FINRA Rules 2310(c), 2320(g), 2341(l)(5), and 5110(h). Rules 2310(c) and 5110(h) do not require internal non-cash compensation arrangements to be based on total production and equal weighting of securities sales.

¹⁷ See 17 CFR 240.151-1(a)(2)(iii)(D).

eliminate provisions in Rules 2320 and 2341 that require internal non-cash compensation arrangements to be based on total production and equal weighting of securities sales.¹⁸ Thus, firms generally would no longer be permitted to sponsor or maintain internal sales contests based on sales of securities within a product category within a limited time, even if they are based on total production and equal weighting. This requirement also would apply to the non-cash compensation provisions governing gifts, business entertainment and training or education meetings. As discussed above, these forms of non-cash compensation may not be preconditioned on achievement of a sales target. Nevertheless, FINRA believes that it must make clear that these provisions do not permit arrangements that conflict with Reg BI.

If the Commission approves the proposed rule change, FINRA will announce the approval of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be the compliance date of Reg BI.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁹ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed changes to FINRA's suitability rules will clarify when Reg BI

¹⁸ See proposed amendments to FINRA Rules 2310(c), 2320(g), 2341(l)(5), and 5110(h).

¹⁹ 15 U.S.C. 78o-3(b)(6).

versus the suitability rules apply, eliminating confusion and allowing firms to focus on compliance with the higher standards in Reg BI, when applicable. At the same time, the change will provide continued protection for customers that are not retail customers covered by Reg BI. Moreover, the removal of the element of control from the quantitative suitability obligation will align this standard with the corresponding quantitative component of the Care Obligation under Reg BI. Finally, the proposed amendments to FINRA's rules on non-cash compensation arrangements will eliminate any potential inconsistency with the requirements of Reg BI.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rulemaking, its potential economic impacts, including anticipated costs and benefits, and the alternatives FINRA considered in assessing how to best meet its regulatory objectives.

Economic Impact Assessment

Reg BI imposes new obligations on broker-dealers and associated persons. As such, FINRA is proposing to modify existing FINRA rules to better align them with the new obligations. The alignment of FINRA rules to Reg BI requirements is expected to provide greater protections to customers against investor abuse from firms and their associated persons. It also reduces uncertainty for firms about which standard applies, thus potentially avoiding unintentional rule violations and reducing compliance costs on the margin. The Economic Impact Assessment analyzes only the impacts directly

attributable to the proposed rule change. The impacts attributable to Reg BI are assumed to have been evaluated by the SEC during the adoption process.

The proposed rule changes would better align the existing FINRA suitability rule with Reg BI's obligations. The proposed rule change would provide that the suitability rule does not apply to any recommendation that is subject to Reg BI. The benefits of this approach are that it would reduce regulatory uncertainty for firms and clarify to retail customers that Reg BI's "best interest" standard applies to recommendations they receive from their broker-dealer and its associated persons. FINRA does not believe that this change will negatively impact firms in any material way, since in almost all cases, retail customer recommendations would be governed by Reg BI, making the application of the suitability rule in these contexts superfluous. Firms also would benefit by focusing their regulatory review of recommendations to retail customers solely on Reg BI, thus increasing the efficiency of such reviews.

The proposed rule change also would eliminate the control element from the quantitative suitability obligation in the suitability rule. This change is consistent with Reg BI, which similarly does not require a showing of control. FINRA had previously analyzed the economic impact of this change when it proposed it in Regulatory Notice 18-13. Potential economic impacts are even less significant at this time, as the SEC has since adopted Reg BI, which expressly excludes the control element and will now apply to a large portion of recommendations (i.e., recommendations to retail customers).

The proposed change is expected to provide greater protections to customers against investor abuse from firms and their associated persons. In cases where excessive trading is alleged, customers would benefit from the reduced burden on FINRA of not

having to prove control while firms and associated persons engaged in excessive trading could experience a higher number of findings of violations. FINRA believes the proposed change would impose minimal, if any, additional compliance burdens on members because FINRA staff understands firms generally perform compliance reviews for excessive trading activity without consideration of whether a broker controls the account.

Lastly, the proposed rule change would align FINRA's non-cash compensation rules with Reg BI's Conflict of Interest Obligation. Reg BI requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited time period, whereas current FINRA non-cash compensation rules permit sales contests for specific types of securities. FINRA believes that this proposed rule change will benefit firms by eliminating regulatory uncertainty created by existing FINRA non-cash compensation rules. To the extent that sales contests and other non-cash compensation arrangements lead brokers to recommend suboptimal investments for customers, banning these practices may benefit customers. However, as for-profit entities, firms may be more limited in their ability to create incentives for their brokers to generate sales.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Comments were neither solicited nor received on this proposed rule change. However, in April 2018, FINRA published Regulatory Notice 18-13, soliciting comment on a proposal to remove the control element from the quantitative suitability obligation in

FINRA Rule 2111, consistent with the then-proposed Reg BI. Eleven comments were received in response to the Notice. A copy of the Notice is attached as Exhibit 2a.

Copies of the comment letters received in response to the Notice are attached as Exhibit 2c.²⁰

Since the publication of Regulatory Notice 18-13, the SEC has adopted Reg BI, which applies to recommendations to retail customers as defined in Reg BI. With the proposed changes to FINRA Rule 2111.08, as discussed above, the suitability rule, including the quantitative suitability obligation, will no longer apply to recommendations to retail customers. As a result, the impact of the removal of the control element of the quantitative suitability obligation is significantly less than when originally proposed. Nevertheless, a majority of commenters to Regulatory Notice 18-13 indicated general support for the proposal to remove the control element from the quantitative suitability obligation of FINRA Rule 2111.²¹ In general, these commenters expressed that the proposed rule change was a reasonable and effective approach to improving the rule,²² and believe it would heighten investor protection.²³ Some commenters raised questions with particular aspects of the proposal or potential unintended consequences.²⁴ Several commenters were not supportive and raised concerns with the proposal.²⁵ Many of the

²⁰ See Exhibit 2b for a list of abbreviations assigned to commenters.

²¹ See Cornell; FSI; NASAA; Pace; PIABA; SEC OIA.

²² See NASAA.

²³ See Cornell; FSI; NASAA; Pace; PIABA.

²⁴ See FSI; PIABA; SER.

²⁵ See Cambridge; Capital Forensics; Keesal; SIFMA.

comments have been rendered moot by the SEC's adoption of Reg BI or the concerns raised have become less relevant given that Reg BI is now the governing standard that applies to recommendations to retail customers. For example, while some commenters supported FINRA's proposal to remove the control element from the quantitative suitability obligation because it was consistent with the approach set forth in the proposed Reg BI,²⁶ several commenters indicated that FINRA's proposal was premature and that FINRA should await the outcome of the SEC's proposed rulemaking.²⁷ FINRA did hold off in filing with the Commission the rule change proposed in Regulatory Notice 18-13. With the final adoption of Reg BI, however, the time is ripe to finalize this change. As a result, for recommendations that remain subject to FINRA Rule 2111 (i.e., recommendations that are not covered by Reg BI), this aspect of the proposed rule change will enable FINRA to more effectively address instances of excessive trading by removing the element of control that currently must be proved to demonstrate a violation and will align this integral element of FINRA's suitability rule with corresponding provision of Reg BI.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

²⁶ See FSI.

²⁷ See Cambridge; Keesal; SIFMA.

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. 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-2020-007 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2020-007. 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 website (<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 website 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. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2020-007 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁸

Jill M. Peterson
Assistant Secretary

²⁸ 17 CFR 200.30-3(a)(12).

Regulatory Notice

18-13

Quantitative Suitability

FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111

Comment Period Expires: June 19, 2018

Summary

FINRA seeks comment on proposed rule amendments that would revise the quantitative suitability obligation under FINRA Rule 2111 (Suitability) to more effectively address instances of excessive trading in customers' accounts. The proposed rule amendments would remove the element of control that currently must be proved to demonstrate a violation, but would not change the obligations to prove that the transactions were recommended and that the level of trading was excessive and unsuitable in light of the customer's investment profile.

The proposed rule text is available in Attachment A.

Questions regarding this *Notice* should be directed to:

- ▶ James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270; or
- ▶ Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by June 19, 2018.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

April 20, 2018

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management

Key Topics

- ▶ Excessive Trading
- ▶ Quantitative Suitability
- ▶ Suitability

Referenced Rules & Notices

- ▶ FINRA Rule 2111
- ▶ Notice to Members 01-23
- ▶ Regulatory Notice 11-02
- ▶ Regulatory Notice 11-25
- ▶ Regulatory Notice 12-25

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

Before becoming effective, the proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).²

Background & Discussion

In 2010, when FINRA amended its longstanding suitability rule, it codified the line of cases on excessive trading (sometimes referred to as “churning”) as the rule’s quantitative suitability obligation.³ Consistent with the case law, FINRA’s quantitative suitability obligation requires a broker who has control over a customer’s account to have a reasonable basis for believing that a series of transactions the broker recommends is not excessive and unsuitable for the customer, even if the individual transactions are suitable when viewed in isolation. However, if a broker does not control a customer’s account, the quantitative suitability obligation does not apply when the broker recommends a series of transactions, even if that series of transactions is excessive and unsuitable for the customer. FINRA has reconsidered the appropriateness of the control element in light of its experience with the rule, the other requirements of the rule and, more recently, the SEC’s proposed Regulation Best Interest (Regulation BI).⁴ FINRA seeks comment on its proposal to amend Supplementary Material .05(c) of Rule 2111 to remove the control element from the quantitative suitability obligation.

A. Actual or De Facto Control Under Quantitative Suitability

Under the quantitative suitability obligation, control can be actual or de facto. In general, actual control exists when a broker has formal discretionary authority over a customer’s account.⁵ A showing of de facto control over a customer’s account depends on whether the customer routinely follows the broker’s advice because the customer is unable to evaluate the broker’s recommendations and exercise independent judgment.⁶ In practice, however, these assessments can be difficult to make and they place a heavy and unnecessary burden on customers by, in effect, asking them to admit that they lack sophistication or the ability to evaluate a broker’s recommendations. This is true even where it is otherwise clear that the broker recommended the transactions and that they were excessive and unsuitable. FINRA is concerned that the control element serves as an impediment to investor protection and an unwarranted defense to unscrupulous brokers.

B. Proposed Amendments

The proposed amendments would remove the phrase “who has actual or de facto control over a customer account” from the quantitative suitability obligation under Supplementary Material .05(c) of Rule 2111. The original basis for requiring the control element is unnecessary under the suitability rule. The inclusion of the control element has its historic roots, in part, in the perceived need to ensure that the culpability for excessive trading rested with the party responsible for initiating the transactions in actions brought pursuant to the antifraud provisions of the federal securities laws.⁷ That concern is not present under FINRA’s suitability rule. Because FINRA must show that the broker *recommended* the transactions in order to prove a Rule 2111 violation, culpability for excessive trading will still rest with the appropriate party even absent the control element.⁸ Moreover, the existence of the control element may impede investor protection by acting as an unintended shield for unscrupulous brokers engaged in excessive trading. Indeed, as the SEC noted in proposing Regulation BI, “the fact that a customer may have *some* knowledge of financial markets or *some* ‘control’ should not absolve the broker-dealer of its ultimate responsibility to have a reasonable basis for any recommendations that it makes.”⁹

Finally, the proposed rule would continue to require FINRA to prove that the series of recommended transactions was excessive and unsuitable, and the proposed amendments would not affect the extensive case law concerning whether trading activity is excessive. Whether trading activity in a customer’s account is excessive would still depend on the facts and circumstances of a particular case and would continue to be assessed in light of the customer’s investment profile.¹⁰ Although no single test defines excessive activity, factors such as turnover rate,¹¹ cost-to-equity ratio¹² or the use of in-and-out trading¹³ may provide a basis for a finding of excessive trading.¹⁴ A turnover rate of six or a cost-to-equity ratio above 20 percent generally is indicative of excessive trading.¹⁵ However, lower ratios have supported findings of excessive trading for customers with very conservative investment objectives,¹⁶ while somewhat higher ratios have not supported findings of excessive trading for some customers with highly speculative investment objectives and the financial resources to withstand potential losses.¹⁷ In addition to these ratios, a pattern of in-and-out trading in relatively short periods of time is a “hallmark” of excessive trading, which, by itself, can provide a basis for finding excessive trading.¹⁸

Economic Impact Assessment

A. Economic Baseline

The economic impact of the proposed rule is dependent on the effects of removing the control element from the quantitative suitability obligation. The control element in the current rule makes it difficult to enforce the quantitative suitability obligation, even where the excessiveness of the trading and the broker's responsibility for the recommendations are clear. As a result, brokers may be able to recommend excessive levels of trading to their customers but avoid disciplinary actions for violating the quantitative suitability obligation because of the difficulty in assessing and proving de facto control over their customers' accounts.

B. Economic Impact

The proposed amendment to Rule 2111 would promote investor protection. Removing the control element from the quantitative suitability obligation would likely increase FINRA's ability to hold brokers responsible for recommendations resulting in excessive trading and serve as a deterrent to possible future misconduct.

As a general proposition, a potential impact of reducing the threshold for establishing a violation of any rule may be that it increases the probability of establishing a violation in the presence of less evidence. However, FINRA does not believe the removal of the control element would lead to disciplinary actions against brokers for excessive trading when the brokers are not responsible for initiating the transactions. In the absence of the control element, FINRA's suitability rule will continue to require FINRA to prove that the broker recommended the transactions and that the transactions were excessive and unsuitable in light of the customer's investment profile. These elements ensure that the culpability for excessive trading continues to rest with the appropriate party. The control element is an unnecessary layer of proof regarding the identity of the responsible party (*i.e.*, the party initiating the transactions) and does not in any way touch on the proof needed to establish the underlying, substantive misconduct (*i.e.*, the excessive trading activity inconsistent with the customer's investment profile).

FINRA believes, moreover, that the proposed change would impose minimal, if any, additional compliance burdens on members because FINRA understands that firms already routinely perform compliance reviews for excessive trading activity without consideration of whether a broker controls the account. The primary cost may be that member firms would need to update written supervisory procedures.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following questions:

1. How does your firm currently monitor for potentially excessive trading in customer accounts? Does your firm consider whether brokers have de facto control over customers' accounts when monitoring for potential excessive trading? If so, how does your firm conduct such monitoring?
2. The proposal would remove the element of control from the quantitative suitability obligation. Would the requirement to prove that the transactions were *recommended* continue to ensure that the culpability for excessive trading rests with the appropriate party?
3. Are there alternative ways to address excessive trading that should be considered? If so, what are the alternative approaches that FINRA should consider?
4. Are there any material economic impacts, including costs and benefits, to investors, brokers and firms that could result from implementation of the proposed amendments?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.
 2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
 3. *See Regulatory Notice 12-25*, at 14 (May 2012). Although the terms “churning” and “excessive trading” are often used interchangeably, churning requires scienter in order to prove a fraud, whereas “excessive trading,” now known as quantitative suitability, does not. *See David A. Roche*, 53 S.E.C. 16, 22 (1997).
 4. On April 18, 2018, the SEC proposed Regulation Best Interest, which would create a new rule under the Exchange Act and establish a “best interest” standard of conduct for broker-dealers and associated persons when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. *See* Regulation Best Interest, Exchange Act Release No. 83062 (Apr. 18, 2018) (Regulation BI Proposing Release). One element of the multi-pronged approach proposed by the SEC would incorporate and go beyond existing suitability obligations under the federal securities laws and FINRA Rule 2111. *Id.* at 10. In incorporating a prohibition on excessive trading, the SEC expressly excluded the “control” element currently present in FINRA’s quantitative suitability rule, noting that the SEC proposed requirement would apply irrespective of whether a broker-dealer exercises actual or de facto control over a customer’s account. *Id.* at 150.
- As a result, in order to satisfy the best interest standard, the SEC proposal would require that a broker-dealer or associated person exercise reasonable diligence, care, skill, and prudence to, among other things, have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer’s best interest when viewed in isolation, is not excessive and is in the retail customer’s best interest when taken together in light of the retail customer’s investment profile. *Id.* at 133. The SEC’s decision to eliminate the “control” element from its proposal is consistent with FINRA’s proposed amendment to the quantitative suitability obligation described herein. FINRA notes, as well, that it will consider the potential impact of Regulation BI, if adopted, on FINRA’s suitability rule more generally.
5. *See Peter C. Bucchieri*, 52 S.E.C. 800, 805 n.11 (1996). Where a broker exercises discretion over an account or engages in unauthorized trading, he or she is viewed as having implicitly recommended the transactions. *See Dep’t of Enforcement v. Murphy*, No. 2005003610701, 2011 FINRA Discip. LEXIS 42, *42 n.33 (NAC Oct. 20, 2011) (“Any violation of the suitability rule also requires proof that there was a ‘recommendation.’ When a broker exercises discretion to make trades or engages in unauthorized trading, . . . such trades are considered to be implicitly recommended for purposes of the suitability rule.”).
 6. *See Harry Gliksmann*, 54 S.E.C. 471, 475 (1999).
 7. *See E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 380 (1945) (stating that a broker “cannot be held guilty of overtrading in an account where transactions are initiated by the customer” and that, with regard to excessive trading liability under the antifraud provisions of the Exchange Act, the question is whether the broker occupied “such a status with respect to the customer that he may be held responsible for excessive trading in such customer’s account”).

8. Although FINRA has not defined “recommendation,” FINRA has provided several guiding principles through past *Notices* that are relevant to the analysis. *See, e.g., Regulatory Notice 12-25; Regulatory Notice 11-02* (January 2011); *Regulatory Notice 01-23* (April 2001). These guiding principles remain applicable for the determination of a recommendation under the proposed amendments to the quantitative suitability obligation.
9. Regulation BI Proposing Release, *supra* note 4, at 155.
10. *See Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at *40-41 (May 27, 2011), *aff’d sub. nom., Cody v. SEC*, 693 F.3d 251 (1st Cir. 2012).
11. Turnover rate is calculated by “dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration.” *Rafael Pinchas*, 54 S.E.C. 331, 339-40 n.14 (1999).
12. The cost-to-equity ratio represents “the percentage of return on the customer’s average net equity needed to pay broker-dealer commissions and other expenses.” *Id.* at 340.
13. In-and-out trading refers to the “sale of all or part of a customer’s portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities.” *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).
14. *See Dep’t of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, *34 (NAC July 30, 2009).
15. *See Howard*, 55 S.E.C. at 1100-01 (“While there is no definitive turnover rate or cost-to-equity ratio that establishes excessive trading, a turnover rate of 6 or a cost-to-equity ratio in excess of 20% generally indicates that excessive trading has occurred.”); *Pinchas*, 54 S.E.C. at 340 (recognizing that “a cost-to-equity ratio in excess of 20% indicates excessive trading”); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980) (recognizing that “an annual turnover rate of six reflects excessive trading”); *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith*, 767 F.2d 1498, 1502 (11th Cir. 1985) (same); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 (6th Cir. 1990) (same).
16. Turnover rates between three and six may trigger liability for excessive trading, depending on the facts and circumstances. *See Cody*, 2011 SEC LEXIS 1862, at *51 (finding turnover rate of 3.21 to be excessive given customers’ conservative investment objectives); *Dep’t of Enforcement v. Stein*, No. C07000003, 2001 NASD Discip. LEXIS 38, at *17 (NAC Dec. 3, 2001) (“Turnover rates between three and five have triggered liability for excessive trading”), *aff’d sub. nom., Jack H. Stein*, 56 S.E.C. 108 (2003). Even turnover rates below three may provide a basis for finding excessive trading. *See Sandra K. Simpson*, 55 S.E.C. 766, 794 (2002) (finding turnover rate as low as 2.10 provided support that trading was excessive for customers with conservative investment objectives); *Jenny v. Shearson, Hammill & Co.*, 1978 U.S. Dist. LEXIS 15077, at *6 (S.D.N.Y. Oct. 6, 1978) (refusing to hold, as a matter of law, that a turnover rate of 1.84 cannot be excessive for any account). In addition, cost-to-equity ratios as low as 8.7 percent have been considered indicative of excessive trading and ratios above 12 percent generally are viewed as strong evidence of excessive trading. *See Cody*, 2011 SEC LEXIS 1862, at *49 and *55 (finding cost-to-equity ratio of 8.7 percent excessive); *Thomas F. Bandyk*, Exchange Act Release No. 35415, 1995 SEC LEXIS 481, at *2-3 (Feb. 24, 1995) (finding cost-to-equity ratios ranging between 12.1 percent and 18 percent excessive).

17. See *DBCC v. Zandford*, No. WA-530, 1989 NASD Discip. LEXIS 39, *21 (DBCC June 7, 1989) (finding that a turnover rate of 9.6 was not excessive under the unique facts of the case, including that the customers had highly speculative investment objectives and financial resources such that they could withstand potential losses).
18. See *Howard*, 55 S.E.C. at 1100-01; *Pinchas*, 54 S.E.C. at 339.

Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2000. DUTIES AND CONFLICTS

* * * * *

2100. TRANSACTIONS WITH CUSTOMERS

* * * * *

2110. Recommendations

* * * * *

2111. Suitability

(a) through (b) No Change.

• • • Supplementary Material: -----

.01 through .04 No Change

.05 Components of Suitability Obligations. Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) through (b) No Change.

(c) Quantitative suitability requires a member or associated person [who has actual or de facto control over a customer account] to have a reasonable basis for believing that a series of [recommended] transactions the member or associated person recommended to the customer account, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

.06 through .07 No Change.

EXHIBIT 2b

List of Written Comments to Regulatory Notice 18-13

1. Joseph P. Borg, North American Securities Administrators Association, Inc. (June 12, 2018) (“NASAA”)
2. Kevin M. Carroll, Securities Industry and Financial Markets Association (June 18, 2018) (“SIFMA”)
3. Rick A. Fleming, SEC Office of the Investor Advocate (June 19, 2018) (“SEC OIA”)
4. Matla Garcia Chavolla and Elissa Germaine, Pace University Law School Investor Rights Clinic (June 19, 2018) (“Pace”)
5. Stacey M. Garrett, Keesal, Young & Logan, P.C. (June 11, 2018) (“Keesal”)
6. William A. Jacobson, Esq. and Joshua N. Shinbrot, Cornell Law School Securities Law Clinic (June 12, 2018) (“Cornell”)
7. Seth A. Miller, Cambridge Investment Research, Inc. (June 19, 2018) (“Cambridge”)
8. Jay Rosen, Capital Forensics, Inc. (June 18, 2018) (“Capital Forensics”)
9. Andrew Stoltman, Public Investors Arbitration Bar Association (June 18, 2018) (“PIABA”)
10. Robin Traxler, Financial Services Institute (June 19, 2018) (“FSI”)
11. Ross Tulman, Securities Experts Roundtable (June 19, 2018) (“SER”)



NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

June 12, 2018

By electronic mail to pubcom@finra.org.

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-13 – Quantitative Suitability

Dear Ms. Piorko Mitchell:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I am submitting this letter in support of FINRA Regulatory Notice 18-13 (the “Proposal”) regarding quantitative suitability obligations.² We believe the Proposal is good for investors because it aligns the evidentiary standard in excessive trading (or “churning”) cases within the suitability standard of care owed to customers.

NASAA has a considerable interest in FINRA rulemaking because our members regulate FINRA member firms and their associated persons. In our view, the Proposal takes a reasonable and effective approach to improve FINRA Rule 2111 by clarifying broker-dealers’ obligations regarding quantitative suitability. We accordingly support the Proposal and encourage its adoption.³

Striking the requirement that a broker-dealer have actual or de facto control over a customer account for the broker-dealer to be potentially liable for churning enhances investor protection in two ways. First, it removes a qualitative element from this otherwise quantitative obligation.

¹ NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

² See FINRA Regulatory Notice 18-13, *Quantitative Suitability – FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111* (Apr. 20, 2018), available at <http://www.finra.org/industry/notices/18-13>.

³ Please note that our support for the Proposal should not necessarily be construed as support for, or opposition to, Regulation Best Interest (“Reg. BI”), as NASAA has not yet taken a position on Reg. BI or the standards of care proposed therein. NASAA is commenting on the Proposal within the context of existing suitability standards.

Jennifer Piorko Mitchell

June 12, 2018

Page 2

Amending this requirement to a fully quantitative analysis will provide a more effective framework for FINRA members to supervise their associated persons. In turn, such close supervision should prevent excessive trading of customer accounts. For this issue, FINRA members should focus their compliance attention on appropriate quantitative metrics – *e.g.*, turnover rates, cost-to-equity ratios and in-and-out trading – when looking for excessive trading, not splitting hairs trying to assess imprecise issues related to the amount of control over a customer’s account.

Second, the Proposal provides a greater likelihood that harmed customers in arbitration proceedings or FINRA enforcement staff in disciplinary actions will be able to recover against bad brokers. Considering that litigants will no longer be required to proffer qualitative evidence of control to establish a prima facie case of excessive trading, these cases will be decided on their quantitative merits. This will deter unscrupulous brokers from engaging in excessive trading because they will no longer be able to escape liability by simply minimizing the appearance of control. Furthermore, the original need for a control element in a churning analysis has been obviated by the incorporation of quantitative suitability into Rule 2111’s overall suitability framework. The recommendation element inherent in Rule 2111 will protect broker-dealers from spurious churning claims. NASAA accordingly agrees with the rationale for the rule amendments set forth in the Proposal.

NASAA appreciates the opportunity to submit its comments in connection with this matter and welcomes the opportunity for further discussion. If you have any questions about this letter, please contact NASAA’s Broker-Dealer Section Chair, Frank Berger-Gilligan (frank.berger-gilligan@tn.gov or 615-532-2375), or General Counsel, A. Valerie Mirko (vm@nasaa.org or 202-737-0900).

Sincerely,

A handwritten signature in black ink, appearing to read "J.P. Borg", written in a cursive style.

Joseph P. Borg
NASAA President
Director, Alabama Securities Commission



June 18, 2018

Via E-Mail to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-13 (proposed amendments to the quantitative suitability obligation under FINRA Rule 2111)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the opportunity to comment on Notice 18-13 (the “Notice” or the “Proposal”).² The Proposal would amend the current quantitative suitability obligation under FINRA Rule 2111 to remove the element of control that currently must be proved to demonstrate a violation. We respectfully submit the following comments and recommendations for your consideration.

FINRA should allow the SEC’s rulemaking process to run its course before proceeding with its own.

As a threshold matter, FINRA points out that the SEC’s proposed Regulation Best Interest – which is currently out for comment until August 7, 2018 – incorporates a prohibition on excessive trading that expressly excludes the control element in FINRA’s quantitative suitability rule.³ Thus,

¹ SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

² FINRA Regulatory Notice 18-13, available at <http://www.finra.org/industry/notices/18-13>.

³ See Notice at fn. 4. See also Exchange Act Release No. 83062 (Apr. 18, 2018) at p. 150, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.

FINRA concludes, the SEC's proposal is consistent with FINRA's proposed amendment.⁴

The better approach would be the reverse. FINRA should allow the SEC proposal to run its course, and then ensure that any subsequent FINRA proposal is consistent with the final SEC rules. If the SEC's final rules eliminate the control element – just as FINRA is proposing here, query whether FINRA would even need its own rule change. And, if the SEC's final rules turn out somewhat differently, then FINRA should consider conforming its rules accordingly. For the foregoing reasons, we respectfully recommend that FINRA set-aside its Proposal pending the completion of the SEC's rulemaking process.

FINRA's investor protection mandate does not extend to facilitating civil recoveries and enforcement actions.

In the Notice, FINRA states that “[it] has reconsidered the appropriateness of the control element in light of its experience with the rule....” This is a euphemistic way of saying that FINRA has not been prevailing in its excessive trading cases as frequently as it would like. This interpretation is reinforced as FINRA explains that “[r]emoving the control element ... would likely increase FINRA's ability to [successfully bring enforcement actions for excessive trading.]”

It also means that claimants are not prevailing in their private civil claims as often as FINRA would like. FINRA likewise acknowledges that the control element places “a heavy and unnecessary burden on customers” and that removing it “increases the probability of establishing a violation in the presence of less evidence.” Thus, FINRA concludes that the control element is “an impediment to investor protection.”

We understand and appreciate FINRA's strong interest in regulating conduct and enforcing standards, but we question whether FINRA's investor protection mandate extends to lowering the evidentiary burden for a cause of action in order to facilitate civil claims and enforcement actions. And if it does so extend, then what would prevent FINRA from stopping there? Why not lower the evidentiary burden for every cause of action – not just excessive trading – if investor protection means making it easier for claimants and FINRA to prevail in their lawsuits?

For the foregoing reasons, the Proposal sets an inappropriate and detrimental precedent and we urge FINRA to reconsider it and reverse course on those grounds.

FINRA should preserve the control element because it provides essential due process protections for financial advisors.

Evidentiary burdens exist for a reason. They are part of due process. They ensure the process is fair to *both* parties. In 2010, when FINRA “codified the line of cases on excessive trading (sometimes referred to as ‘churning’),” it accepted that the control element was part of the burden of proof. Now it seeks to substitute its judgement by fiat for that of the many courts and judges who created the legal precedent in the first place.

⁴ *Id.* at fn. 4.

In the Notice, FINRA states that “[t]he inclusion of the control element has its historic roots ... in the ... need to ensure that the culpability for excessive trading rested with the party responsible for initiating the transactions....” (emphasis added). But that is simply not true. It’s not just about who “initiated” the transaction.

FINRA’s own footnote proves this point. If the customer initiates the transactions, then clearly the financial advisor cannot be liable for overtrading. But if the financial advisor “initiates” (i.e. recommends) the transactions, the standard is different. In that case, the question is “*whether the broker occupied ‘such a status with respect to the customer that he may be held responsible for excessive trading in such customer’s account.’*”⁵ That is essentially a restatement of the control element.

The control element is an essential due process protection for the financial adviser. It ensures that the customer cannot have it both ways, i.e., if the high-volume trading is profitable, then the customer takes the profits and doesn’t complain. If, however, the high-volume trading is not, then the customer can force the firm to reimburse the losses under an excessive trading claim. To avoid this outcome, the customer should continue to be held to a standard of showing that the financial advisor controlled the account, and regardless, in order to adequately defend him or herself, the financial advisor should be allowed to introduce evidence of the customer’s sophistication, experience, involvement in the investment decisions, and history of rejecting investment recommendations in the past (i.e., prove that the financial advisor did not control the account).

For the foregoing reason, FINRA should preserve the control element of an excessive trading claim. Alternatively, if FINRA strikes the control element, it should at a minimum issue formal guidance acknowledging that financial advisors may introduce, and panels must continue to consider, evidence that the financial advisor did not in fact control the account.

The retention of the “recommendation” requirement does not restore the due process that the Proposal erodes by eliminating the control element.

In the Notice, FINRA essentially states, don’t worry if we strike the control element because “*culpability for excessive trading will still rest with the appropriate party*” because “*FINRA must show that the broker recommended the transactions in order to prove a Rule 2111 violation.*” (Emphasis supplied). Now it is clear why FINRA seeks to retroactively revise the historical purpose of the control element to make excessive trading liability appear to rest entirely on whomever initiated the transaction.⁶

As discussed above, however, the recommendation is clearly *not* all that matters. Financial advisors should continue to be able to introduce, and hearing panels should be required to consider and weigh, evidence of the customer’s sophistication, experience, involvement in the investment decisions, and history of rejecting investment recommendations in the past.

FINRA approvingly cites to the following statement in the SEC’s proposed Regulation Best Interest, “*the fact that a customer may have some knowledge of financial markets or some ‘control’*

⁵ See Notice at fn. 7 and accompanying text.

⁶ *Id.*

*should not absolve the broker-dealer of its ultimate responsibility to have a reasonable basis for any recommendation that it makes.”*⁷ (Emphasis supplied). We do not disagree and are not suggesting otherwise. But the level of the customer’s control matters, and it should continue to be appropriately considered and weighed by adjudicators and regulators.

By the same token, while some knowledge and some control are not dispositive, it should also be the case that the fact that a customer exercised control over the account (by virtue of his or her sophistication, knowledge, exercise of independent judgment, and ultimate control over the decision-making, for example) should not allow the customer to prevail on an excessive trading claim for what was essentially their *own* excessive trading. FINRA guidance should clarify that a broker-dealer has no duty to prevent a customer from engaging in his or her own financial ruin through their own excessive trading.

Thus, the retention of the recommendation requirement does not cure the elimination of the control requirement, particularly where the recommendations are made to a customer who clearly has the sophistication and ability to evaluate those recommendation, and who has a well-established history of asserting final decision-making authority over those recommendations. Even if FINRA ultimately decides to eliminate the control element, control still matters, and FINRA should issue appropriate guidance to recognize a financial advisor’s due process right to raise control element issues, as discussed above.

If the control element is eliminated, then hearing and enforcement sanctions should be revised.

If FINRA ultimately decides to strike the control element, then it will be essentially creating a new, lesser offense, with a lower burden of proof, making it easier for customers to prevail in arbitration and for FINRA to prevail in enforcement actions. Churning is a violation of Rule 10b-5 and requires proof of scienter and control, among other things. FINRA’s prospective new excessive trading claim would require neither proof of scienter nor control.

If FINRA proceeds, then it would be appropriate for FINRA to concurrently establish new hearing and enforcement sanctions guidelines that recognize this new, far less serious offense. Likewise, FINRA should concurrently ensure that hearing officers receive training on the significant differences in severity between churning, on the one hand, and excessive trading on the other. Finally, FINRA should issue guidance on the statutory disqualification implications for violations of each of these distinct causes of action.

* * *

⁷ Exchange Act Release No. 83062 (Apr. 18, 2018) at p. 155, available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.

If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,

A handwritten signature in cursive script that reads "Kevin M. Carroll". The signature is written in black ink and is positioned above a horizontal line.

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: ***via e-mail to:***
Robert L.D. Colby, Chief Legal Officer, FINRA
Richard W. Berry, Executive Vice President and Director, FINRA-DR



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
INVESTOR ADVOCATE

June 19, 2018

Submitted Electronically (pubcom@finra.org)

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 18-13, Quantitative Suitability

Dear Ms. Mitchell:

The Office of the Investor Advocate¹ at the Securities and Exchange Commission (“Commission” or “SEC”) appreciates this opportunity to provide comments in regard to the issues raised in the Financial Industry Regulatory Authority, Inc.’s (“FINRA”) Regulatory Notice 18-13 (the “Notice”).² The Office of the Investor Advocate has a strong interest in potential rule changes involving FINRA’s supervision of broker-dealer conduct, and particularly the rules that promote fair dealing and ethical sales practices, because they play such a key role in protecting retail investors.

I. Introduction

The Notice describes a potential change to what FINRA must prove to demonstrate that a broker-dealer has violated its quantitative suitability obligation, sometimes described as a prohibition on excessive trading or “churning.” The proposal would amend FINRA’s Rule 2111, which imposes general suitability obligations on all broker recommendations for particular transactions and investment strategies.³ Currently, to demonstrate that a broker has violated its quantitative suitability obligation, FINRA must prove: (1) an element of control over the customer’s account by the broker; (2) that the transactions were recommended by the broker; and (3) that the level of trading was excessive and unsuitable in light of the customer’s investment profile.⁴ Based on its experience with this rule in

¹ Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934, 15 U.S.C. § 78d(g)(4) (2012), the Office of the Investor Advocate at the Securities and Exchange Commission is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations. In furtherance of this objective, we routinely review and examine the impact on investors of proposed rulemakings of SROs, including those issued by FINRA, and make recommendations to the SROs proposing those rulemakings. As appropriate, we make formal recommendations and/or utilize the public comment process to help ensure that the interests of investors are fully considered as rules are adopted.

² FINRA, REG. NOTICE 18-13, QUANTITATIVE SUITABILITY (Apr. 20, 2018), <http://www.finra.org/industry/notices/18-13> [hereinafter NOTICE 18-13].

³ See generally FINRA Rule 2111 (2012), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

⁴ See NOTICE 18-13, *supra* note 2, at 1.

practice, FINRA is considering removing the requirement that it prove a level of control in order to find a violation.⁵

The Office of the Investor Advocate has reviewed the Notice and the comments received to date. In brief, we believe that FINRA would be well served by the change, which would allow it to better protect the interests of retail investors by holding brokers responsible for recommendations that result in excessive trading. In addition, the proposed change will serve as a deterrent to possible future misconduct. We support the proposed amendments, and we encourage FINRA to adopt them.

II. Background

FINRA Rule 2111 (Suitability) imposes three main suitability obligations on broker-dealers when making a recommendation to a customer for a particular transaction or investment strategy: (1) reasonable-basis suitability; (2) customer-specific suitability; and (3) quantitative suitability.⁶ The first requires a broker to have a reasonable basis to believe, based on reasonable diligence, that a recommendation is suitable for at least some investors.⁷ The second requires a broker, based on a particular customer's investment profile,⁸ to have a reasonable basis to believe that the recommendation is suitable for that particular customer.⁹ Together, these first two requirements make clear that a broker must have a firm understanding of both the product and the customer.

The third obligation, relevant here, currently requires a broker who has control, actual or de facto, over a customer account to have a reasonable basis for believing that a *series* of recommended transactions, even if each might be suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.¹⁰ In initially drafting the rule text earlier this decade, FINRA sought to codify a line of existing cases on excessive trading or "churning."¹¹

As described in the Notice, under the case law, *actual* control exists when a broker has formal discretionary authority over a customer's account, whereas a showing of *de facto* control over a customer's account depends on whether the customer routinely follows the broker's advice because the customer is unable to evaluate the broker's recommendation and exercise independent judgment.¹² FINRA suggests that, in practice, an assessment of de facto control can be difficult to make and places a heavy and unnecessary burden on customers by, in effect, asking them to admit that they lack

⁵ See *id.*

⁶ See FINRA Rule 2111, *supra* note 3, at Supplementary Material .05, Components of Suitability Obligation.

⁷ See FINRA Rule 2111, Supp. Material .05(a).

⁸ See FINRA Rule 2111(a), which notes 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."

⁹ See FINRA Rule 2111, Supp. Material .05(b).

¹⁰ See FINRA Rule 2111, Supp. Material .05(c).

¹¹ See FINRA Regulatory Notice 12-25, at 14 (May 2012),

<http://www.finra.org/sites/default/files/NoticeDocument/p126431.pdf>, ("The quantitative suitability obligation under the new rule simply codifies excessive trading cases").

¹² See NOTICE 18-13, *supra* note 2, at 2.

sophistication or the ability to evaluate their broker's recommendation.¹³ FINRA is proposing to remove the element of control that currently must be proved to demonstrate a violation, but is not otherwise proposing to change the existing standard involving excessive trading.

III. Analysis

The Securities Exchange Act of 1934 requires that the rules of a registered securities association such as FINRA be designed, in relevant part, to protect investors and the public interest.¹⁴ Here, FINRA is proposing to remove the control element from the quantitative suitability obligation, while retaining the requirements that FINRA demonstrate both that the transactions were recommended by the broker and that the level of trading was excessive and unsuitable in light of the customer's investment profile.

As described in the Notice, the inclusion of the control element had historic roots, in part, in the perceived need to ensure that the culpability for excessive trading rested with the party responsible for initiating the transactions in proceedings brought pursuant to the antifraud provisions of the federal securities laws.¹⁵ FINRA argues that requiring the control element is unnecessary under the quantitative suitability rule. In essence, FINRA Rule 2111 already ensures that FINRA will only be able to punish the responsible party, as FINRA is required to show that the broker *recommended* the transaction. Therefore, regulatory culpability still rests with the appropriate party, even absent the control element.¹⁶

In my experience, which includes 15 years of handling enforcement actions against broker-dealer firms and registered representatives, "bad" brokers make money in two general ways: (1) they sell a bad product to a lot of people; or (2) they get a customer to trade frequently. I am quite familiar with the elements required to prove excessive trading, and I agree with the concern expressed by FINRA in the Notice that the control element serves as "an impediment to investor protection and an unwarranted defense to unscrupulous brokers." Churning is often difficult to prove because the victim unwittingly consents to the trading, not understanding the full import of the trading strategy, which can undermine the control element. Egregious cases can then go unpunished.

This kind of rule change would go a long way to deterring this type of abusive practice. The proposed amendments will provide a self-regulatory body with a more appropriate way to police its members and thereby protect vulnerable investors. At the same time, FINRA will still be required to prove that the series of recommended transactions was excessive and unsuitable. Investors will still be free to trade as often as they want, but professionals would be required to consider whether it is appropriate to recommend such a strategy.

As to the Notice's Question 4, concerning the material economic impacts of the proposed change, including its potential costs and benefits,¹⁷ we suggest that FINRA review its own disciplinary actions against churning brokers. We are confident this would show that the proposed rule change, by both enhancing deterrence and punishing "bad" brokers, would significantly benefit investors. These

¹³ See NOTICE 18-13, *supra* note 2, at 1.

¹⁴ See 15 U.S.C. § 78o-3(b)(6) (2010).

¹⁵ See NOTICE 18-13, *supra* note 2, at 3.

¹⁶ See *id.*


¹⁷ See NOTICE 18-13, *supra* note 2, at 5.

types of cases highlight the harm caused by churning, where a broker may seek to generate thousands of dollars in commissions and, at the same time, the excessive trading results in thousands of dollars of customer losses.¹⁸ For example, just this past fall, FINRA's hearing panel ordered a broker to pay more than \$155,000 in restitution to a blind, elderly widow who was harmed by, in part, the broker's practice of frequently buying and selling securities within a week or two, engaging in more than 700 trades over a three year period and paying approximately \$210,000 in commissions while losing more than \$175,000 in her account.¹⁹

IV. Conclusion

We commend FINRA for proposing changes that should directly benefit retail investors by both improving FINRA's ability to punish churning brokers and sending a message that should deter it. We are completely supportive of the proposed change contained in the Notice and encourage FINRA, after reviewing all the comments, to move quickly in seeking Commission approval for its proposed rule change.

Should you have any questions, please do not hesitate to contact me or Senior Trading and Markets Counsel Adam Moore at (202) 551-3302.



Rick A. Fleming
Investor Advocate

¹⁸ See, e.g., FINRA News Release, FINRA Bars Former CISC Broker for Churning Customer Accounts (Aug. 6, 2015), <http://www.finra.org/newsroom/2015/finra-bars-former-cisc-broker-churning-customer-accounts>.

¹⁹ See FINRA News Release, FINRA Hearing Panel Bars Broker for Defrauding Elderly, Blind Customer (Nov. 9, 2017), <http://www.finra.org/newsroom/2017/finra-hearing-panel-bars-broker-defrauding-elderly-blind-customer>; http://www.finra.org/sites/default/files/Werner_Extended_Hearing_Panel_Decision_110917.pdf.

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June 19, 2018

VIA EMAIL

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-13, Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111

Dear Ms. Mitchell:

The Investor Rights Clinic at the Elisabeth Haub School of Law at Pace University, operating through John Jay Legal Services, Inc. (PIRC),¹ welcomes the opportunity to comment on FINRA's proposal to amend the quantitative suitability obligation under Rule 2111. Specifically, FINRA proposes removing the element of control that currently must be proved to demonstrate a violation, but would still require a showing that the transactions were recommended and that the level of trading was excessive and unsuitable in light of the customer's investment profile. PIRC supports the proposed amendments as they aim to more effectively address instances of excessive trading in customers' accounts by alleviating the burden of proving an unnecessary element to succeed in a claim.

Currently, under the quantitative suitability obligation, control can be actual or de facto. While actual control exists when a broker has formal discretionary authority over a customer's account, a showing of de facto control generally depends on whether the customer routinely follows the broker's advice due to the customer's inability to evaluate the broker's recommendations and exercise independent judgment. PIRC agrees with FINRA that these assessments place a heavy and unnecessary burden on customers. The proposed amendments

¹ PIRC opened in 1997 as the nation's first law school clinic in which law students, for academic credit and under close faculty supervision, provide pro bono representation to individual investors of modest means in arbitrable securities disputes. See Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000); see also Press Release, Securities Exchange Commission, SEC Announces Pilot Securities Arbitration Clinic To Help Small Investors - Levitt Responds To Concerns Voiced At Town Meetings (Nov. 12, 1997), available at <http://www.sec.gov/news/press/pressarchive/1997/97-101.txt>.

eliminate the control element while reinforcing the recommendation element of quantitative suitability, thereby ensuring that culpability for excessive trading rests with the appropriate party. Thus, PIRC agrees with FINRA that the proposed amendments will eliminate an unwarranted defense for brokers, resulting in increased investor protection and accountability for wrongdoers.

Respectfully submitted,

Pace Investor Rights Clinic

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Via E-Mail – pubcom@finra.org

Ms. Jennifer Piorko Mitchell
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FINRA
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Washington, D.C. 20006-1506

Re: Comments regarding FINRA Regulatory Notice 18-13 (April 20, 2018)

Dear Ms. Mitchell:

On behalf of Keesal, Young & Logan, P.C.,¹ we are writing to submit our comments regarding FINRA’s proposed amendments to Rule 2111, as set forth in Regulatory Notice 18-13 (April 20, 2018).

Summary of Comments

For the last 60 years, courts across the United States have held that liability for churning requires proof that the broker had actual or *de facto* control over the trading. Where the broker does not control the trading, churning does not exist. In 2010, FINRA amended Rule 2111 to codify and reflect the long-standing line of cases on excessive trading (sometimes referred to as “churning”) as the rule’s “quantitative suitability” obligation. (Reg. Not. 18-13, p. 2.)

¹ Since 1970, Keesal, Young & Logan has represented companies and individuals associated with the financial services industry. Our attorneys have appeared in thousands of securities arbitration proceedings conducted by the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, Pacific Stock Exchange, American Stock Exchange, National Association of Securities Dealers, American Arbitration Association, Judicial Arbitration and Mediation Services (JAMS), National Futures Association and the Municipal Securities Rulemaking Board. We also have significant experience handling regulatory proceedings initiated by the Securities and Exchange Commission, FINRA, CFTC, CBOE and state regulators. Our attorneys frequently speak on topics related to the securities industry in general and FINRA procedures in particular. The opinions and views expressed in this letter are solely those of Keesal, Young & Logan.

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Although the law on churning has not changed over the last six decades, FINRA now proposes to amend Rule 2111 to *eliminate* the requirement that FINRA prove the broker “controlled” the trading in order to establish that the broker violated his or her “quantitative suitability obligation” under Rule 2111. FINRA now concludes that the original basis for requiring the “control element” under Rule 2111 is “unnecessary.” (Reg. Not. 18-13, p. 3.) FINRA does not identify what has led it to take the unprecedented step of enacting a rule that is contrary to settled law, nor does it identify what has changed in the customer-broker relationship to justify its conclusion that the “control element” is no longer a necessary element of churning. Rather, FINRA now takes the perplexing position that it need only establish that a broker *recommended* a transaction to establish that a broker violated his or her quantitative suitability obligation, if the trading is excessive in light of the customer’s investment profile. This position flatly ignores the customer’s vital role in exercising the final say as to whether or not to buy or sell securities that have been recommended. Equally troubling, the elimination of the “control element” is a radical and unwarranted departure from more than 60 years of settled American jurisprudence on the issue of churning. All of the United States Courts of Appeals that have addressed the issue have uniformly held that the broker’s actual or *de facto* “control” over the trading is an essential element of churning.² The federal securities regulations and FINRA Rules should be in harmony with prevailing law, not contrary to it.

FINRA also suggests that the proposed amendment to Rule 2111 is necessary to align Rule 2111 with the Securities and Exchange Commission’s recently proposed “Regulation Best Interest.” (Reg. Not. 18-13, n. 4.) Notably, Regulation Best Interest has not been finalized or adopted; indeed, the comment period for Regulation Best Interest remains open until August 7, 2018. (*See* SEC Release No. 34-83062, p. 42 (April 18, 2018).) It is premature for FINRA to amend its rules to conform to a *proposed* regulation. Additionally, to the extent that Regulation Best Interest (and specifically the “Care Obligation”) proposes to permit regulators to establish a violation of the “quantitative suitability obligation” without establishing that the broker exercised actual or *de facto* control over the trading, it too should be revised to expressly state that the quantitative suitability rule proposed at 17 C.F.R. §240.151-1(a)(2)(ii)(C) applies only where the broker exercises actual or *de facto* control over the trading.³

Finally, FINRA states that that the proposed amendment to Rule 2111 is necessary because establishing that the broker controlled the trading in an account places a “heavy and unnecessary burden on customers by, in effect, asking them to admit that they lack

² See the decisions cited in the Appendix hereto.

³ For the reasons set forth herein, we similarly urge the SEC to conform Regulation Best Interest and the “Care Obligation” proposed at 17 C.F.R. §240.151-1(a)(2)(ii)(C) to long-standing precedent governing churning claims and to require that a violation of the Care Obligation can exist only where the broker had actual or *de facto* control over the trading.

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sophistication or the ability to evaluate a broker's recommendation." (Reg. Not. 18-13, p. 2.) For that reason, FINRA is concerned that the control element serves as an "impediment" to investor protection. As defense lawyers in securities cases for more than 45 years, we have yet to encounter customers who were reluctant to allege lack of sophistication or the inability to evaluate a broker's recommendation, even when confronted with facts establishing precisely the opposite. Even so, removing the "control element" from Rule 2111 will not ease any perceived "burden" on customers because Rule 2111 will not establish a new legal standard for churning cases. There is no private right of action for an alleged violation of industry rules. Indeed, the Securities and Exchange Commission admits that proposed Regulation Best Interest will not create any new private right of action or right of rescission, nor does the SEC intend such a result. (SEC Release No. 34-83062, p. 42.) In other words, establishing *civil* liability for churning will still require a customer to prove the broker controlled the trading in the account, the trading was excessive given the customer's investment objectives, and the broker acted with fraudulent intent.

We support FINRA's mission of investor protection. Of course, that mission must exist in tandem with the equally important goal of providing a fair regulatory framework for brokers. For the reasons set forth in this letter, we urge FINRA's Board of Governors to reject the proposed change to Rule 2111 and to retain FINRA's obligation to establish that a broker "controlled" the trading in an account in order to prove a violation of Rule 2111's quantitative suitability obligation.

1. The proposed amendment to Rule 2111 will not promote investor protection because there is no private right of action for an alleged violation of FINRA rules.

FINRA is concerned that the control element is an "impediment" to investor protection, but the proposed amendment to Rule 2111 would not address that concern. Customers who claim that their account was excessively traded (churned) still will be required to establish all of the elements of churning required by law (including that the broker exercised actual or *de facto* control over the trading in the account, and acted with fraudulent intent). It has been settled for many years that investors cannot state a claim for civil liability based on an alleged violation of an industry rule. *See Brady v. Calyon Sec. (USA) Inc.*, 406 F. Supp. 2d 307, 312 (S.D.N.Y. 2005) (defendant's motion to dismiss granted because rules of NYSE and NASD do not create a private right of action); *SSH Co. v. Shearson Lehman Bros.*, 678 F. Supp. 1055, 1058 (S.D.N.Y. 1987) ("[T]he [NYSE and NASD] rules contain no express provisions for civil liability and the courts in this circuit have refused to imply a private right of action to enforce these rules."); *Halkin v. VeriFone Inc. (In re VeriFone Sec. Litig.)*, 11 F.3d 865, 870 (9th Cir. 1993) ("It is well established that violation of an exchange rule will not support a private claim"); *Carrott v. Shearson Hayden Stone, Inc.*, 724 F.2d 821, 823 (9th Cir. 1984) (summary judgment properly granted to defendant because there is no private right of action under NYSE

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rules); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 680–81 (9th Cir. 1980) (Securities Exchange Act does not provide a private cause of action for violation of stock exchange rules or NASD rules). Therefore, even if FINRA Rule 2111 is modified, and even if proposed Regulation Best Interest is adopted, neither rule will create any new private right of action or right of rescission. The SEC is explicit about this. (SEC Release No. 34-83062, p. 42) (“Furthermore, we do not believe that Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result.”)

Having differing standards for “quantitative suitability” under FINRA Rule 2111 and for “churning” under federal law will not aid investor protection; it will only promote investor (and possibly arbitrator) confusion. Moreover, if arbitrators errantly base an award in favor of a public customer on the more lenient standard of proposed amendment to Rule 2111 in disregard of the prevailing and controlling law on churning (including the required element of “control”), the resulting award could be subject to vacatur in several circuits as a result of the arbitrators’ manifest disregard of the law. *Stolt-Nielsen SA v. AnimalFeeds Int’l Corp.*, 548 F.3d 85, 91–92 (2d Cir. 2008), *rev’d on other grounds*, 559 U.S. 662, 130 S. Ct. 1758, 176 L. Ed. 2d 605 (2010) (the “manifest disregard” doctrine allows a reviewing court to vacate an arbitral award only in “those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent.”); *Wachovia Sec., L.L.C. v. Brand*, 671 F.3d 472, 483 (4th Cir. 2012) (manifest disregard is “a two-part test that a party must meet in order for a reviewing court to vacate for manifest disregard: ‘(1) the applicable legal principle is clearly defined and not subject to reasonable debate; and (2) the arbitrator refused to heed that legal principle.’”); *Coffee Beanery, Ltd. v. WW, L.L.C.*, 300 F. App’x 415, 418 (6th Cir. 2008) (citing *Merrill Lynch, Pierce, Fenner & Smith v. Jaros*, 70 F.3d 418, 421 (6th Cir. 1995)) (“Thus, an arbitrator acts with manifest disregard if ‘(1) the applicable legal principle is clearly defined and not subject to reasonable debate; and (2) the arbitrators refused to heed that legal principle.’”); *Johnson v. Wells Fargo Home Mortg., Inc.*, 635 F.3d 401, 414 (9th Cir. 2011) (although the words “manifest disregard for law” do not appear in the FAA, they have come to serve as a judicial gloss on the standard for vacatur set forth in FAA § 10(a)(4).)

True investor protection demands reliability and consistency. In that regard, FINRA Rules should be consistent with, not contrary to, established law. The proposed amendment to Rule 2111 should be rejected. Like established federal law, Rule 2111 should continue to require FINRA to establish that a broker “controlled” the trading in an account in order to prove a violation of Rule 2111.

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2. The customer's control over the trading should continue to be a defense to regulatory actions alleging excessive trading.

The proposed amendment to Rule 2111 would enable FINRA to establish that a broker had violated his or her “quantitative suitability” obligation even where the broker did not control the trading; in other words, in a situation where the broker did not control the trading, a broker would have a complete defense to a civil claim for churning but could still face regulatory exposure for a potential violation of Rule 2111. There is no justification for creating this disparate standard. Establishing that a broker “controlled” the trading in an account has been an essential element of churning for more than 60 years. *Every* United States Circuit Court of Appeals that has addressed churning has concluded that the broker’s actual or *de facto* control of the trading is an essential element of churning.⁴ The element of “control” serves an important purpose in churning cases, and it should be no different simply because the complaining party is a regulator.

a. Recommendations do not equal control.

FINRA states that, because it must show that the broker recommended the transactions in order to prove a Rule 2111 violation, culpability for excessive trading will still rest with the appropriate party even absent the control element. (Reg. Not. 18-13, p. 3.) But it is well-settled that recommendations do not equal control. *Sheldon Co. Profit Sharing Plan & Tr. v. Smith*, 828 F. Supp. 1262, 1273 (W.D. Mich. 1993). If a customer is fully able to evaluate his broker’s advice and agrees with the broker’s suggestions, the customer retains control of the account. *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977) (citing *Carras v. Burns*, 516 F.2d 251, 258–59 (4th Cir. 1975)). “As long as the customer has the capacity to exercise the final right to say ‘yes’ or ‘no,’ the customer controls the account.” *Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391, 1394 (D. Md. 1986) (citing *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982)).

The control element serves an important purpose that would be eviscerated by the proposed amendment to Rule 2111. Requiring proof that the broker exercised actual or *de facto* control over the trading — not that he or she merely *recommended* it — ensures that responsibility for the transaction rests with the appropriate party. Evidence that a customer followed his broker’s recommendations does not determine who controlled the account. The customer’s sophistication in securities transactions and independent evaluation about the handling of the account are at least equally important. *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983). To hold otherwise would prevent imputing control to the highly sophisticated investor who actively monitors his account but typically does not disagree with his

⁴ See Appendix hereto.

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broker's recommendations. *Id.* As the United States Court of Appeals for the Ninth Circuit recognized more than 35 years ago, “[i]t simply cannot be construed to mean that the sophisticated investor is not in control of his account simply because he usually follows the recommendations of his broker. As long as the customer has the capacity to exercise the final right to say ‘yes’ or ‘no,’ the customer controls the account.” *Follansbee*, 681 F.2d at 677.

By allowing a broker's mere “recommendation” instead of “control” to form the basis of a regulatory violation of proposed amended Rule 2111, FINRA will effectively eliminate the significance of the customer's participation in the trading. This is exactly the outcome the United States Court of Appeals for the First Circuit found was improper in *Tiernan, supra*. By removing consideration of the customer's involvement in the strategy and trading, proposed amended Rule 2111 would give FINRA the ability to penalize brokers for trading decisions made by sophisticated customers who actively participate in—and who at times direct—the activity in their accounts but typically do not disagree with their brokers' recommendations. FINRA's role as a self-regulatory organization should be to oversee a *fair* regulatory framework, not one that penalizes brokers for the informed, involved decisions of their customers.

b. “Solicited” transactions do not equal control.

By its terms, the quantitative suitability component of Rule 2111 applies only where the broker recommends a series of transactions to a customer. The parallel component of the SEC's proposed Regulation Best Interest (the “Care Obligation” at 17 C.F.R. §240.151-1(a)(2)(ii)) likewise applies only where the broker recommends transactions to a customer. Where a customer directs a trade, a strategy or a series of transactions, the quantitative suitability component of Rule 2111 and Regulation Best Interest would not apply. (SEC Rel. 34-83062, p. 80.) Although we agree that Rule 2111 and the related “Care Obligation” of Regulation Best Interest should not apply to unsolicited transactions, whether a trade ticket is marked “solicited” or “unsolicited” does not always reflect who recommended a transaction and certainly does not reflect who controlled the trading. For those reasons, retention of the “control” element is critical and cannot be satisfied by merely reviewing a trade ticket to determine whether it was marked “solicited” or “unsolicited.” Brokers often consider an order “solicited” if they discuss the security with the customer before the trade is executed and the broker agrees with the customer's suggestion, even if the broker does not believe that the trade is in the “best interests” of the customer, and even if the broker did not recommend the transaction. Consider these three scenarios:

Scenario one: A wealthy, experienced customer has a concentrated position in stock with a very low cost basis. Although the broker recommends selling some stock and diversifying into a laddered bond portfolio, the customer rejects the advice, goes on margin and intends to use the margin proceeds to buy more equities in the same industry because the customer knows that industry best. The customer discusses his intended stock purchases with

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the broker. The broker gives the customer information about the securities the customer proposes to buy, and the customer decides which stocks to buy. In this scenario, the broker may mark the trade ticket “solicited” because he had provided the customer with information about the securities (an approach that comports with the policies of many member firms), but the trading strategy and the security selection originated with the customer, and — under long-standing principles governing churning claims — the customer controlled the trade. In this scenario, removing consideration of the customer’s role and simply ascertaining whether the trade ticket was marked “solicited” or “unsolicited” would fail to present an accurate picture of the transaction and the broker-client relationship. Moreover, investor protection would not be served by finding the broker in violation of proposed amended Rule 2111 in this scenario, although that is certainly a risk in the absence of the “control” element of quantitative suitability.

Scenario two: In the same example described above, the market declines a short time later and a margin call requires the customer to sell securities to meet the call. The customer, after discussion with his broker about all of his securities, chooses to sell the newly-purchased securities because their sale will not result in capital gains tax consequences. Again, the broker may mark the trade ticket “solicited” because he had discussed the securities with the customer. On the face of this paperwork, the trading would appear to be solicited, short-term trading, possibly in violation of proposed amended Rule 2111, even though the broker did not recommend the strategy or the security transactions, and even though the customer clearly controlled the trading. Investor protection would not be furthered by finding the broker in violation of Rule 2111 in this scenario, although the language of the proposed amendment presents that possibility.

Scenario three: In the same example described above, the customer decides to take less than 5% of his substantial liquid net worth and engage in short term trading, including some day-trading and Initial Public Offerings. The broker recommends against short term trading. The customer insists because he likes the “action” of day-trading and IPOs. The customer asks the broker to help him select securities for the purpose of short term trading, and the broker does so. Again, the broker may mark the trade tickets “solicited” because he had discussed the specific securities with the customer, even though the entire strategy was *contrary to* the broker’s recommendation. And yet again, investor protection would not be furthered by finding the broker in violation of Rule 2111 in this scenario, although the language of the proposed amendment presents that possibility.

The decision in *Nunes*, 635 F. Supp. at 1394, demonstrates that the customer’s actions are far more important than whether a trade is marked “solicited.” Mr. Nunes claimed that his account had been churned and that most of the trades were solicited by his broker. *Id.* at 1396. Mr. Nunes had experience in the securities markets, was in telephone contact with his broker on a regular basis and continued similar trading with another brokerage firm after he left Merrill Lynch. *Id.* at 1395. The court concluded that the number of trades that were solicited

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was immaterial in light of Mr. Nunes's involvement in the account, as shown by the almost daily telephone calls between Mr. Nunes and his broker and their frequent meetings. *Id.* at 1394. The court granted summary judgment to Merrill Lynch, concluding that, "even assuming that many trades were solicited, this would not amount to control since Mr. Nunes clearly possessed 'sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable.'" *Id.* (citing *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982)) (citation omitted). The *Nunes* decision illustrates why the element of control should not be removed from a determination of whether churning occurred. If control is removed as an element of churning (aka "quantitative suitability"), the fact finder may look solely to whether a trade was marked "solicited" or "unsolicited," without examining the facts behind the paperwork.

Courts overwhelmingly find that a broker's actual or *de facto* control over the trading in a customer's accounts— not simply his or her "recommendations" — is required to establish churning. A finding of potential regulatory liability under Rule 2111 should also require FINRA to establish that the broker exercised actual or *de facto* control over the trading.

Conclusion

As securities attorneys, we share FINRA's desire to protect the public from unscrupulous brokers. However, the rights of member firms and associated persons must not be trampled in the process. To reiterate, we agree that churning — where *all* of its elements (including control) have been established — is a serious transgression. But, the customer's role in the transactions is an important factor that cannot be minimized or worse, eliminated. The legal standard for a potential regulatory violation of Rule 2111 should continue to require proof that the broker controlled the trading.

For the reasons set forth above, we respectfully urge FINRA's Board of Governors to reject the proposed amendment to Rule 2111.

Very truly yours,



Stacey M. Garrett

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On behalf of Keesal, Young & Logan, PC

Attachment: Appendix of decisions

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June 11, 2018

APPENDIX

Every United States Circuit Court of Appeal that has addressed churning has concluded that the broker's actual or *de facto* control of the trading is an essential element of churning, as the following decisions demonstrate:

1st Circuit: "Churning is commonly said to have three elements: (1) control of the customer's account by the broker, either explicit or *de facto*; (2) excessive trading in light of the customer's investment objectives; and (3) scienter -- the required state of mind for liability under Section 10(b) and Rule 10b-5." *Rizek v. SEC*, 215 F.3d 157, 162 (1st Cir. 2000).

2nd Circuit: "In order to recover, the customer must show that the dealer effectively exercised control over trading in the account and manipulated the account to his benefit." *Newburger, Loeb & Co.*, 563 F.2d at 1069.

3rd Circuit: "The Commodity Futures Trading Commission, the federal regulatory agency responsible for the administration and enforcement of the Commodities Exchange Act, 7 U.S.C. § 1 et seq. (1982), defines churning as "the excessive trading of an account *by a broker with control of the account*, for the purpose of generating commissions, without regard for the investment or trading objectives of the customer." *Bowley v. Stotler & Co.*, 751 F.2d 641, 644 (3d Cir. 1985) (emphasis added).

4th Circuit: "Churning occurs when a broker, exercising control over the volume and frequency of trading, abuses his customer's confidence for personal gain by initiating transactions that are excessive in view of the character of the account." *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975).

5th Circuit: "Churning occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of the client's interests Once an investor proves that: (1) the trading in his account was excessive in light of his investment objectives; (2) the broker in question exercised control over the trading in the account; and (3) the broker acted with the intent to defraud or with willful and reckless disregard for the investor's interests the broker may be held liable for a violation of the federal securities laws under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b(5)." *Laird v. Integrated Res.*, 897 F.2d 826, 838 (5th Cir. 1990)

6th Circuit: "Churning consists of three elements, *all of which must be present*: (1) the trading must be excessive in light of the customer's investment objectives; (2) the *broker must exercise control over the account*; (3) the broker must act with intent to defraud or with willful and reckless disregard of the customer's interests." *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 489 (6th Cir. 1990) (citing *M & B Contracting Corp. v. Dale*, 795 F.2d 531, 533 (6th Cir. 1986)) (emphasis added).

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7th Circuit: “There is no single test or formula for proving that churning has occurred, but it is generally said that a plaintiff must show (1) that the broker exercised control over the transactions in the account and (2) that the amount of trading was excessive.” *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 (7th Cir. 1983).

8th Circuit: “To establish churning, it is necessary to prove that the dealer has control of the account and that there has been excessive trading in it.” *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 133 (8th Cir. 1970)

9th Circuit: “It is settled that when a broker, unfaithful to the trust of his customer, churns an account *in the broker's control* for the purpose of enhancing the broker's commission income and in disregard of the client's interest, there is a violation of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., and Securities and Exchange Commission Rule 10b-5. There must be a concurrence of all three elements . . .” *Follansbee*, 681 F.2d at 676 (emphasis added); *see also Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980).

10th Circuit: “Under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, a broker may be held liable for violation of federal securities laws once an investor proves that: (1) the trading in his account was excessive in the light of his investment objectives; (2) the *broker in question exercised control over the trading in the account*; and (3) the broker acted with an intent to defraud or with willful and reckless disregard for the investor's interests.” *Hotmar*, 808 F.2d at 1385 (emphasis added).

11th Circuit: “The plaintiff must prove three elements in order to establish a cause of action for churning: ‘(1) the trading in his account was excessive in light of his investment objectives; (2) the broker in question exercised control over the trading in the account; and (3) the broker acted with the intent to defraud or with willful and reckless disregard for the investor's interest.’” *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith*, 767 F.2d 1498, 1501 (11th Cir. 1985) (citing *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416–17 (11th Cir. 1983)).



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June 12, 2018

(Via E-mail: pubcom@finra.org)

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 18-13 (Quantitative Suitability)

Dear Ms. Mitchell,

The Cornell Securities Law Clinic (the "Clinic") welcomes the opportunity to provide feedback on the request for comment (the "Request" or the "Notice") of the Financial Industry Regulatory Authority ("FINRA") on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111. The Clinic is a Cornell Law School curricular offering, in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see: <http://www.securities.lawschool.cornell.edu/>

For the reasons set forth below, the Clinic strongly supports the Proposed Amendments to Rule 2111, which would eliminate the requirement that a customer prove the member or associated person had actual or de facto control over the customer's account.

FINRA Rule 2111 requires members and associated persons who recommend a transaction or investment strategy to have a reasonable basis to believe that (1) the recommended investment is suitable for at least some advisors; (2) the recommended investment is suitable for a particular customer based upon that customer's investment profile; and (3) when the member or associated person has actual or de facto control over a customer account, that a series of recommended transactions, even if suitable in isolation, are not excessive and unsuitable when taken together in light of the customer's investment profile.

Currently, under FINRA Rule 2111, Supplementary Material .05(c), in order to prove that a member or associated person violated the quantitative suitability obligation, a customer must show that (1) the member or associated person had actual or de facto control over the customer's account; and (2) a series of recommended transactions were (3) excessive and unsuitable when taken together in light of the customer's investment profile.



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The Proposed Amendments to Rule 2111, which eliminate the requirement that a customer prove that the member or associated person had actual or de facto control over the customer's account will (1) protect investors by deterring unscrupulous associated persons from engaging in excessive trading; and (2) ensure that the culpability for excessive trading rests with the appropriate party. We agree with the justification for these changes set forth at pages 2-3 of the Notice.

Culpability for excessive trading will continue to rest with the appropriate party under the Proposed Amendments. Members and associated persons would not be responsible for a violation of the quantitative suitability rule unless they undertook an affirmative step to recommend an unsuitable series of transactions. Requiring members and associated persons to prove that a transaction was not recommended would deter those individuals from recommending a series of individually suitable transactions at the customer's expense.

Conclusion

The Clinic strongly supports the Proposed Amendments to the quantitative suitability obligation.

Respectfully Submitted,

//William A. Jacobson//

William A. Jacobson, Esq.
Clinical Professor of Law
Director, Cornell Securities Law Clinic

//Joshua N. Shinbrot//

Joshua N. Shinbrot
Cornell Law School, Class of 2019



VIA ELECTRONIC MAIL: pubcom@finra.org

June 19, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-13: Request for Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111

Dear Ms. Mitchell,

Cambridge Investment Research, Inc. (“Cambridge”) appreciates the opportunity to comment on Regulatory Notice 18-13: Request for Comment on Proposed Amendments to the Quantitative Suitability Obligation under FINRA Rule 2111. Cambridge understands this amendment is intended to address instances of excessive trading in customer accounts.

Cambridge supports implementation of thoughtful, well-crafted, and clearly understandable rules; and commends FINRA’s efforts to achieve that goal. Cambridge also supports FINRA’s goal to protect the investing public and agrees that “unscrupulous brokers” should be held accountable for wrongful excessive trading. However, Cambridge believes this measure will have unintended negative consequences. As such, Cambridge does not support the removal of the requirement for FINRA to show either actual or de facto control by a registered person to prove violations of FINRA Rule 2111.

The assertion that proof of the control or de facto control element is an unnecessary barrier to proving representative misconduct is not justified. It is Cambridge’s belief that the analysis given in the Regulatory Notice referred to above is based on a misguided premise; specifically that a “heavy and unnecessary burden” is placed upon investors by “asking them to admit that they lack

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cambridge@cir2.com | www.cir2.com

sophistication or the ability to evaluate a broker's recommendation." Changing this rule based on this notion is misdirected, and it is highly problematic that a presumed lack of candor of investors regarding their sophistication would be relied upon as a sufficient justification to alter the rule. Investors' minds change, circumstances change, and investors often challenge the suitability of a series of transactions if those transactions do not result in a preferred or expected outcome.

While Cambridge does not dispute the fact FINRA may have interacted with timid and uninformed investors in its efforts to determine independent judgment, we do not believe it is reasonable to amend a rule which in turn would essentially accommodate unrestrained challenges to the investment decisions made by registered persons and their clients. Registered persons should be able to rely on the consent and instruction of their clients for any trade or series of trades suitable at the time. Removal of the control element would allow a series of recommendations, which the registered person believed to be suitable at the time, to later be deemed unsuitable in the context of the investor's recollections or revelations, and only after the series has occurred. Often, in these cases, the investor approved the transactions, and even may have directed the transactions along the way.

The control element protects registered persons from unwarranted claims of churning. The proposed change would allow for the imputation of misconduct where none had originally existed. The barrier in place today does not simply require an affirmative answer to the question of whether control "existed" within the context of those transactions. It requires an affirmative response to the more relevant question, which is whether the registered person "exercised" control over those transactions. Absent proof of control or de facto control, a chain of investor initiated and controlled transactions, even occurring outside the confines of that registered person's knowledge and control, could be used to assert a quantitative suitability violation simply because the registered person "recommended" the security. In this instance, an investor who, on his own initiative, takes a registered person's recommendation too far, would be afforded an escape for his own errant acts. Therefore, Cambridge believes a violation of the rule should be tied to a finding that the registered person attempted to manipulate the investor into engaging in unsuitable transactions. This is accomplished by a showing that the registered person had actual or de facto control over the investor's account and not simply an assessment of the facts and circumstances in "light of the customer's investment profile."

Additionally, the proposed alteration to this rule will likely result in greater litigation and increased costs of defense for member firms. By changing the rule, FINRA would open the door to allow for a strict quantitative measure of trading activity to be used as a litigation and enforcement mechanism against those registered persons who may simply be complying with investor requests or directions. While these quantitative measures are highly informative in any churning analysis, it is imperative to retain the qualitative involvement of the client. Absent any qualitative consideration of control, remorseful investors could simply crunch the numbers to figure out whether they land on the winning side of the issue. Those whose chances look good will likely take action even though the responsibility for the trades may lie on them.

Lastly, Cambridge requests FINRA wait to implement any new rules regarding suitability until the Securities and Exchange Commission's proposed "Regulation Best Interest" is finalized. Pausing to ensure continuity of rules would be extremely helpful to member firms and would allow for the

employment of a uniform standard. Cambridge would be happy to further discuss any of the comments or recommendations in this letter with FINRA.

Respectfully submitted,

// Seth A. Miller

Seth A. Miller
General Counsel
Senior Vice President, Chief Risk Officer



Capital Forensics, Inc.

1530 E. Dundee Road, Suite 333 | Palatine, IL 60074 | T 888-970-1700 | P 847-392-0900

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506
Via E-Mail: pubcom@finra.org

Re: Comments regarding FINRA Regulatory Notice 18-13

Dear Ms. Mitchell:

FINRA has requested comments concerning RN-18-13 which proposes to eliminate the requirement of actual or de facto control over an account to determine a violation of quantitative suitability, under Rule 2111. This change is grounded on the theory that the account control element is unnecessary to ensure that culpability for trading activity rests with the appropriate party. I respectfully disagree.

The suitability rule recently underwent a substantive transformation with an effective date of July 2012. Now it is being suggested that the necessity of proving “control” when bringing a claim of “excessive trading”/“churning” should be removed. By removing the factor of control, one would be removing both the moving factors behind the transaction(s) and the ultimate responsibility for approving and or directing transactions. The consequences would be to alleviate any sense of personal responsibility of the client for investments and strategies. This is despite the fact that the client may be the driving force behind the types and timing of recommendations, and or other factors, which would demonstrate to the “trier of the facts” that the client was in control of the activity in the account, thereby negating any possibility of a finding of “churning” in the account. Yet 18-13 wants to ignore the issue of control. It appears that they no longer wish to even call it churning, but instead just call it “quantitative suitability.”

According to Notice to Members 18-13, when FINRA originally attempted to codify and change the suitability rules, it apparently codified the line of cases on excessive trading (historically referred to as “churning”).

In order to prevail in a churning claim, one must prove 3 elements as follows:

1. Excessive trading
2. Control
3. Scierter

Excessive trading is an element of churning; however, you can have a separate and distinct finding of excessive trading in regard to a suitability claim. Given the nature of the clients’ objectives and risk parameters, you can show a violation there without control or scierter. Aren’t the authors of 18-13 eliminating the claim of churning? Regardless of who controlled the account activity, the charge of excessive trading will be brought and there will be little or no defense possible of control by the client.

The regulatory notice states that it would not change the obligations to prove that the transactions were “recommended” and that the level of trading was excessive and unsuitable in light of the customer’s investment profile. It would seem to this writer that the reliance upon a “recommendation” as a factor would be more reasonable if we had a Notice to Members which clearly enabled an advisor to make such a recommendation without fear of legal consequences since they were consistent with the client’s profile or as a direct request from the client for a particular type or timing of a recommendation. This is at the clients’ direction to the firm that the recommendations given should fall within those risks and those parameters. As long as they are consistent with and verified by the client, they should be in a “safe harbor” for the account executive whether it be conservative or speculative. This, however, would have to recognize speculative recommendations and activity are consistent with speculative objectives.

The proposed notice should be effective for clients pursuing claims against inappropriately recommended activities as well as provide the strongest of defenses for those relying upon the speculative, or other, profiles for those in

reliance upon the clients' verification of those objectives in order to make recommendations. If the control element is dropped, the recommendation element should be enhanced. For instance, a series of recommendations (that are obviously not churning) would be given a presumption of suitability if they are within the client profile. The client would have the burden of rebutting that presumption.

Imagine the person who wants to trade options and seeks out a broker to make recommendations of options of value at the time. He is making recommendations to quality and timing of the transactions in a short-term vehicle but both the impetus and control belong to the client.

Imagine the client who determines he or she desired to invest in gold and natural resources. That person regularly looks for advice and recommendations on oil, gold, silver, etc. and the shifts which occur in those fields. Recommendations are being made but they are being driven by the client. Panels will continually look for the impetus, the driving force, the cause, or simply the control.

The examples wherein someone was found to be in control, regardless of age, gender or education, is a question of fact and none other. These facts are first reviewed by supervisory teams at the firms. If need be, the regulators and or legal system adjudicates based upon the facts. Control has always been one of those necessary factors and it should remain as such.

Fortunately, we have mature markets with well thought out case law generated by our legal system. These cases and their jurisprudence have outlined the essential factors in these churning cases and even give guidance to the appropriate methods for determining culpability as well as damages in various types of churning cases. This history gives others trying cases of this nature a structure of fairness, legal rights, and duties in such cases. This guidance would become relatively worthless in churning cases if control is removed. The system, the structure, and the rule currently work. Integrity is the bedrock of our system. By removing control, you remove culpability. By removing culpability, you remove accountability and the integrity of the system.

Let's ask the question: Do we not trust the arbitrators and or judges to be fair? Do we think we should intervene to determine the outcome by establishing rule changes like this? I think not!

As one can easily see, this transformation of the rules of conduct to remove the act of churning because it requires an element of control is at best confusing. In reality, it is a manipulation of the appropriate language which appears to have the purpose of trying to eliminate the established procedures for the analysis and potential defense of brokers who work with speculative and aggressive accounts. These accounts may desire to take greater risks. These avenues are available to those who wish to risk their investable resources to achieve higher returns. These clients, older or younger, may very well be in control of the types and timing of recommendations and the ultimate transactions. This is, has been, and hopefully always will be part of the capitalistic systems inherent in the markets. Even if the SEC proposal on Best Interest becomes the rule, the presumption approach would be useful to protect broker dealers from unwarranted claims of unsuitability.

As indicated above, this suggested change does not help anyone. This change would be counterproductive for our system as a whole, including the investors, the advisors, the regulators, and the arbitrators or judges. In other words, it weakens the foundation and sacrifices the integrity of the system.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Jay Rosen', with a long, sweeping horizontal line extending to the right.

Jay Rosen
Chairman Emeritus
Capital Forensics, Inc.
jay@capitalforensics.com
(847) 392-0900



PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

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June 14, 2018

Via email to pubcom@finra.org

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-13
Quantitative Suitability

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in arbitration by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) that govern the sales practices of brokers.

FINRA requests comment on its proposal to amend the quantitative suitability obligation under FINRA Rule 2111. Under the current rule, an investor receives the protections of the quantitative suitability obligation only when a broker exercise control over an investor’s accounts. This requirement codifies case law, recognizing broker control as a necessary element to a churning claim. However, such a requirement potentially harms investors, as it forces investors to understand and determine whether the necessary level of control exists to benefit from the protection.

FINRA’s suitability rule generally is premised on the notion that a broker has certain obligations before speaking and making any recommendations to investors. For example, a broker must understand the risks and rewards associated with a recommended security or strategy.¹ A broker must also have an understanding of an investor’s

¹ See FINRA Rule 2111.05(a).

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Ms. Jennifer Piorko Mitchell

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profile to be able to determine if it is reasonable to recommend a particular security or strategy.² These obligations are not premised on a broker having discretion over an investor's account, nor are they dependent on the investor lacking sophistication. However, under FINRA Rule 2111, a broker must control an investor's account before the firm's supervisory structure must consider whether the quantity of transactions is suitable.³

When making a recommendation, a broker should have a reasonable basis for believing the recommendation is suitable for an investor, both in isolation and in the context of other recommendations made by the broker. Oftentimes, in arbitrations involving allegations of excessive trading, a broker justifies the volume of trading simply with the investor's agreement with (or failure to complain about) the transactions. All too often, brokers will argue that the pattern of trading, or the benefits that accrue to them, are irrelevant absent the improper exercise of discretion. This is contrary to the main thrust of the FINRA suitability rule: a broker should act in the best interest of the investor.⁴ It is important for investor protection that the rule be amended to eliminate the necessity of control from the quantitative suitability obligation.

Further, PIABA is concerned with the following statement within the Notice:

A turnover rate of six or a cost-to-equity ratio above 20 percent generally is indicative of excessive trading. However, lower ratios have supported findings of excessive trading for customers with very conservative investment objectives, while somewhat higher ratios have not supported findings of excessive trading for some customers with highly speculative investment objectives and the financial resources to withstand potential losses.⁵

The statement implies that turnover rates of less than 6, and cost-to-equity ratios of less than 20 may be considered excessive only for customers with very conservative investment objectives. While turnover rates greater than six have generally been held to be evidence of excessive trading, rates lower than six have triggered liability for excessive trading for investors with a range of investment objectives.⁶ For example, the SEC has recognized that, "for a conservative investor, an annualized turnover rate of two is suggestive, of four is presumptive, and, of six or more, is conclusive of excessive trading."⁷ FINRA has found that a turnover of 3.27 was excessive for an investor with a moderate risk tolerance.⁸ With respect to cost to equity ratios, rates as low as 8.7% has been found to be excessive trading.⁹

² See FINRA Rule 2111.05(b).

³ See FINRA Rule 2111.05(c).

⁴ See e.g., FINRA Rule 2111 (Suitability) FAQ, answer to question 7.1 ("In interpreting FINRA's suitability rule, numerous cases explicitly state that 'a broker's recommendations must be consistent with his customers' best interests.' The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."), available at <https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>.

⁵ FINRA Regulatory Notice 18-13, 3 (April 20, 2018), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-13.pdf.

⁶ See e.g., *Dept. of Enforcement v. Marlboro*, 2017 WL 3142386, at *11 n.23 (excessive trading has been evidenced with turnovers as low as two).

⁷ *In the Matter of Alfred M. Bauer & J. Stephen Stout*, S.E.C. Release No. 134, 68 S.E.C. Docket 2635, Release No. ID - 134, 1999 WL 4904, at *25 (Jan. 7, 1999).

⁸ *Dept. of Enforcement v. Marlboro*, 2017 WL 3142386, at *13 (N.A.S.D.R. 20017).

⁹ *In the Matter of the Application of Cody*, S.E.C. Release No. 64565, 2011 WL 2098202, *13 (2011).

Ms. Jennifer Piorko Mitchell

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The statement in the Notice fails to recognize the FINRA and SEC decisions which recognize much lower rates as evidence of excessive trading in accounts where there are not “very conservative” investment objectives. In fact, a cost-to-equity ratio of 20 is prohibitively high, even for the most aggressive accounts. Such an account would have to produce returns in excess of 20% just to cover the cost of investing and thereby break even. Considering the historical return for the S&P 500 is a little less than 10%,¹⁰ a cost-to-equity ratio even approaching 10% would be excessive for nearly all investors, not just those with very conservative investment objectives.

PIABA requests that FINRA clarify the statement included in the Notice, and state that a churning analysis is unique to each investor, and that lower ratios may be excessive for investors, not only those with “very conservative investment objectives.”

PIABA thanks FINRA for reviewing the quantitative suitability obligations. PIABA is supportive of the proposed amendments and looks forward to commenting on a formal rule proposal to eliminate the control element.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Andrew Stoltman". The signature is fluid and cursive, with a long horizontal stroke at the end.

Andrew Stoltman

¹⁰ See Investopedia, “What is the average annual return for the S&P 500?” (“According to historical records, the average annual return for the S&P 500 since its inception in 1928 through 2017 is approximately 10%.”), available at <https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp>.



VIA ELECTRONIC MAIL

June 19, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-13 | FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111 (Notice)

Dear Ms. Mitchell:

On April 20, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on proposed amendments (Proposed Amendments) to FINRA Rule 2111 (Suitability). FINRA Rule 2111 establishes firms' and advisors' suitability obligations and, among other things, codifies case law concerning excessive trading - a practice that is also referred to as "churning."¹ In particular, supplementary material .05 of FINRA Rule 2111, imposes a quantitative suitability obligation on FINRA's members. That obligation summarily requires firms and advisors to have "a reasonable basis for believing that a series of recommended transactions" are suitable and not excessive, in light of the customer's investment objectives.²

Under the current iteration of FINRA Rule 2111, advisors' and firms' quantitative suitability obligation is triggered only if the advisor, or the firm, has control over the customer's account. Under the Proposed Amendments, that obligation would be triggered where the advisor or the firm recommends a series of transactions, regardless of whether the advisor controls the account.³ FINRA's decision to eliminate the "control" component from the quantitative suitability obligation is predicated upon: (a) its experience with this aspect of the rule; as well as (b) FINRA's desire to align its rules with the Securities and Exchange Commission's (SEC's) proposed Regulation Best Interest (SEC Regulation Best Interest).⁴

¹ See FINRA Regulatory Notice 18-13 (April 20, 2018) at p. 2, available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-13.pdf (Notice); see also FINRA Rule 2111 (Suitability) FAQs, at Q6.1 & A6.1, available at <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>.

² *Id.*; see also FINRA Rule 2111 (Suitability) FAQs, at Q6.1 & A6.1, available at <http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq>.

³ See, generally, Notice.

⁴ See Notice at p. 2.

The Financial Services Institute⁵ (FSI) appreciates the opportunity to comment on this important proposal. While FSI is still formulating its comments in response to SEC Regulation Best Interest, FSI believes that advisors should act in the best interest of their clients and that SEC Regulation Best Interest is a positive step toward industry stakeholders reaching a consensus regarding what that means. FSI further believes that, where practicable, laws and regulations pertaining to the same class of persons, should be harmonized. Also, most important to FSI and its members, the Proposed Amendments heighten investor protection.

FSI notes that the Proposed Amendments may lead to a substantial increase in churning cases and resulting enforcement actions. Nonetheless, we believe this potential is substantially outweighed by investor protection considerations. Thus, FSI supports FINRA's proposal.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.⁶ These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).⁷

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate \$48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly \$6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.⁸

⁵ The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

⁶ Cerulli Associates, Advisor Headcount 2016, on file with author.

⁷ The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

⁸ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

Discussion

FSI appreciates the opportunity to comment on FINRA's proposal. As noted above, FSI supports the proposal as an important attempt to harmonize the laws and rules governing firm's and advisor's obligations and, in particular, the standard of care that advisors should exercise when recommending a series of securities transactions. FSI, however, notes that this proposal lowers the bar for regulators to bring excessive trading cases against firms and advisors. Moreover, for churning cases brought under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 (Exchange Act), the proposal may have the unintended consequence of more advisors or firms being statutorily disqualified. These concerns are discussed in greater detail below.

I. FSI Supports FINRA's Rule Proposal

A. Introduction and Background

In 2011, the SEC approved FINRA's proposal to amend its suitability rules to, among other things, create three categories of suitability obligations.⁹ Those categories, which are encompassed in the current iteration of the rule, are reasonable basis suitability, customer specific suitability, and quantitative suitability.¹⁰ Specific to the Proposed Amendments, the latter category requires that:

"...a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation."¹¹

Whether an advisor has actual control over a customer's account is relatively clear. An advisor who has discretionary authority over the customer's account has actual control of the account.¹² However, *de facto* control is a concept largely established by case law,¹³ that requires a facts and circumstances analysis, and is thus less clear and open to multiple interpretations. More specifically, an advisor has *de facto* control over a customer's account where the customer routinely follows the advisor's advice, the customer is unable to evaluate

⁹ See FINRA Regulatory Notice 11-02 (Regulatory Notice 11-02) at fn. 11, citing Dane S. Faber, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (February 10, 2004), available at <http://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf>

¹⁰ See FINRA Rule 2111, Sup. Mat. 05 (a) – (c).

¹¹ See FINRA Rule 2111, Sup. Mat. 05 c).

¹² See FINRA Dep't of Enforcement v. Medeck, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *34(July 30, 2009).

¹³ See Notice at p. 2.

that advice and the customer the customer is unable to utilize his or her independent judgement.¹⁴

B. FSI Supports the Proposed Amendments

i. The Proposed Amendments Attempt to Harmonize Advis or's Regulatory Obligations

The Proposed Amendments, like the SEC's Regulation Best Interest proposal, would apply to advisor's quantitative suitability obligations, regardless of whether the advisor had actual or *de facto* control over the customer's account.¹⁵ FSI supports the Proposed Amendments because while the final version of SEC Regulation Best Interest may vary from the SEC's pending proposal, the Proposed Amendments are a step towards harmonizing advisors' obligations when recommending a series of transactions to customers. This harmonization is something that FSI has long since supported. Specifically, FSI believes that compliance is substantially more efficient and effective when regulators create a regulatory environment that enables advisors and firms to operate under a clear, concise and uniform (or, at least, substantially similar) set of rules.

Notably, FINRA guidance has previously pointed out that an advisor's recommendations should be in a customer's best interest.¹⁶ In fact, FINRA has advised that, "the suitability rule and the concept that a broker's recommendation must be consistent with the customer's best interests are inextricably intertwined."¹⁷ FINRA has also clarified that acting in a customer's best interest does not require firms or advisors to offer the least expensive security.¹⁸ Instead, it only necessitates that the recommendation be suitable in light of the customer's investment objectives.¹⁹ If adopted, those concepts would, in many respects, be codified in SEC Regulation Best Interest.

ii. The Proposed Amendments Heighten Investor Protection

Under the Proposed Amendments, an advisor's or firm's suitability obligations would be triggered at the time the advisor recommends a series of securities transactions. Fundamentally, this change comports with the basic guiding principles of FINRA Rule 2111, i.e., holding advisors to a specific standard of care where they recommend securities transaction versus when the

¹⁴ See Medeck, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *34.

¹⁵ See, e.g., S.E.C. Release No. 34-83062; File No. S7-07-18 (April 18, 2018) at p. 150 (stating that the SEC believes "it is appropriate to incorporate this existing, well-established obligation, which would ... promote consistency and clarity regarding this obligation. However, [the SEC believes] it is appropriate to expand the scope of this requirement by applying it irrespective of whether a broker-dealer exercises actual or *de facto* control over a customer's account, thereby making the obligation consistent with the current requirements for "reasonable basis suitability" and "customer specific suitability." Accordingly, [SEC] Regulation Best Interest would include the existing "quantitative suitability" obligation, but without a "control" element.")

¹⁶ See Regulatory Notice 11-02 at fn. 11, citing Dane S. Faber, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (February 10, 2004; see also SEC Staff Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, at p. 59 (Jan. 2011) (IA/BD Study), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

¹⁷ See FINRA Regulatory Notice 12-25, pp. 3-4 (May 2012) (explaining that "[t]he suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."), available at http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_25.pdf.

¹⁸ *Id.*

¹⁹ *Id.*

investor decides to, independently, engage in a securities transaction. Thus, FSI believes the Proposed Amendments heighten investor protection.²⁰

C. Investor Protection Considerations Outweigh the Unintended Collateral Consequences of the Proposed Amendments

By eliminating the control element of advisors' and firms' quantitative suitability obligations, the standard of proof for churning cases will be substantially lower. Thus, the proposal may result in more churning cases than would otherwise be brought, resulting in more fines, penalties and awards being assessed against firms and advisors. Moreover, additional adverse findings of churning, specifically those resulting in findings that the firm or advisor willfully violated Section 10(b) and Rule 10b-5 of the Exchange Act, may lead to more firms and advisors becoming statutory disqualified. However, FSI notes that this potential uptick of findings of churning, and the resulting consequences, are substantially outweighed by heightened investor protection and reducing the potential for advisors and firms to be subject to varying standards of care when recommending a series of securities transactions.

FSI does, however, encourage FINRA to look back at the Proposed Amendments, within three to five years of them becoming effective, to assess whether the Proposed Amendments are consistent with the version of SEC Regulation Best Interest that is ultimately adopted. That look back should also consider whether implementation and enforcement of the Proposed Amendments are achieving the Proposed Amendments' regulatory objective.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,



Vice President, Regulatory Affairs & Associate General Counsel

²⁰ See FINRA Letter of Acceptance, Waiver and Consent, No. 2014043542408 between FINRA Dep't of Enforcement and David Awad (September 14, 2015), available at http://www.finra.org/sites/default/files/Awad_AWC_091515.pdf.



SECURITIES EXPERTS ROUNDTABLE

www.securitiexpert.org

June 19, 2018

via e-mail – pubcom@finra.org

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

Dear Ms. Piorko Mitchell:

The Securities Experts Roundtable (SER) Board of Directors, on behalf of our membership, respectfully submits comment on Regulatory Notice 18-13. SER is a national professional association of securities experts with an interest in the improvement of securities dispute resolution. SER is claimant/respondent neutral. Collectively, our experts have testified in thousands of NASD and FINRA arbitrations, as well as in most all arbitration forums, state courts, and federal court.

RN 18-13 footnote 11 relies on the turnover calculation methodology referenced in *Rafael Pinchas*, 54 S.E.C. 331, 339-40 n.14 (1999):

Turnover rate is calculated by “dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration.”

The Pinchas case follows the method set forth in *Looper & Co* 38 S.E.C. 294, 297n.6 (1958). Some of our members pointed out that practitioners have customarily used average equity as the denominator in the formula. There is support for the position. For example, in NASD Disciplinary Proceeding No. E9B2003033701, December 12, 2006, NASD Division of Enforcement v. Keith Howard Medeck, the NASD staff used the “modified Looper formula.” The modified formula substitutes “average equity” for “average investment” in the denominator for accounts that primarily hold securities as opposed to cash. We note that many member firms use the modified formula to prepare exception reports designed to identify excessive trading.

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Ms. Jennifer Piorko Mitchell
June 18, 2018
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SER does not take a position as to which method is preferable. We believe that the appropriate methodology is case specific and that determination is properly left to the trier of fact. We encourage FINRA to modify RN 18-13 footnote 11 to indicate that different turnover calculation methodologies may be appropriate depending on the specific facts and issues presented at hearing.

Respectfully submitted on behalf of our members,

A handwritten signature in blue ink, appearing to read "Ross Tulman", with a long horizontal flourish extending to the right.

Ross Tulman
President, Securities Experts Roundtable
rpt@tiagroup.com

EXHIBIT 5

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

FINRA RULES

* * * * *

2000. DUTIES AND CONFLICTS

* * * * *

2100. TRANSACTIONS WITH CUSTOMERS

2110. Recommendations

2111. Suitability

(a) through (b) No Change.

••• Supplementary Material: -----

.01 through .04 No Change.

.05 Components of Suitability Obligations. Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) through (b) No Change.

(c) Quantitative suitability requires a member or associated person [who has actual or de facto control over a customer account] to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and

the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

.06 through .07 No Change.

.08 Regulation Best Interest. This Rule shall not apply to recommendations subject to SEA Rule 151-1 ("Regulation Best Interest").

* * * * *

2300. SPECIAL PRODUCTS

2310. Direct Participation Programs

(a) through (b) No Change.

(c) Non-Cash Compensation

(1) No Change.

(2) Restriction on Non-Cash Compensation

In connection with the sale and distribution of direct participation program or REIT securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided below [in this provision]. Non-cash compensation arrangements must be consistent with the applicable requirements of SEA Rule 151-1 ("Regulation Best Interest") and are limited to the following:

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target [or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (c)(2)(D)];

(ii) through (iii) No Change.

(iv) the payment or reimbursement by the offeror is not conditioned by the offeror on the achievement of a sales target [or any other non-cash compensation arrangement permitted by paragraph (c)(2)(D)].

(D) through (E) No Change.

(d) No Change.

2320. Variable Contracts of an Insurance Company

(a) through (f) No Change.

(g) Member Compensation

In connection with the sale and distribution of variable contracts:

(1) through (3) No Change.

(4) No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided below [in this provision]. Notwithstanding the provisions of paragraph (g)(1), the following non-cash compensation arrangements are permitted provided that they are consistent with the applicable requirements of SEA Rule 151-1 ("Regulation Best Interest"):

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) No Change.

(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target [or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (g)(4)(D)];

(iii) through (iv) No Change.

(v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target [or any other non-cash compensation arrangement permitted by paragraph (g)(4)(D)].

(D) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

[(i) the member's or non-member's non-cash compensation arrangement, if it includes variable contract securities, is based on the total production of associated persons with respect to all variable contract securities distributed by the member;]

[(ii) the non-cash compensation arrangement requires that the credit received for each variable contract security is equally weighted;]

(i[ii]) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

[(iv)ii) the record keeping requirement in paragraph (g)(3) is satisfied.

(E) No Change.

* * * * *

2341. Investment Company Securities

(a) through (k) No Change.

(l) Member Compensation

In connection with the sale and distribution of investment company securities:

(1) through (4) No Change.

(5) No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided below [in this provision]. Notwithstanding the provisions of paragraph (l)(1), the following non-cash compensation arrangements are permitted provided that they are consistent with the applicable requirements of SEA Rule 151-1 ("Regulation Best Interest"):

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) No Change.

(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target [or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (1)(5)(D)];

(iii) through (iv) No Change.

(v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target [or any other non-cash compensation arrangement permitted by paragraph (1)(5)(D)].

(D) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

[(i) the member's or non-member's non-cash compensation arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member];

[(ii) the non-cash compensation arrangement requires that the credit received for each investment company security is equally weighted;]

(i[ii]) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

[(iv)ii] the recordkeeping requirement in paragraph (1)(3) is satisfied.

(E) No Change.

(m) through (n) No Change.

* * * * *

5000. SECURITIES OFFERING AND TRADING STANDARDS AND PRACTICES

5100. SECURITIES OFFERINGS, UNDERWRITING AND COMPENSATION

5110. Corporate Financing Rule — Underwriting Terms and Arrangements

(a) through (g) No Change.

(h) Non-Cash Compensation

(1) No Change.

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash

compensation, except as provided below [in this provision]. Non-cash compensation arrangements must be consistent with the applicable requirements of SEA Rule 151-1 (“Regulation Best Interest”) and are limited to the following:

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member’s prior approval to attend the meeting and attendance by a member’s associated persons is not preconditioned by the member on the achievement of a sales target [or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (h)(2)(D)];

(ii) through (iii) No Change.

(iv) the payment or reimbursement by the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target [or any other non-cash compensation arrangement permitted by paragraph (h)(2)(D)].

(D) through (E) No Change.

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by paragraphs (h)(2)(C) through (E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and

value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with paragraphs (h)(2)(C) through (E).

(i) No Change.

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CAPITAL ACQUISITION BROKER RULES

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200. DUTIES AND CONFLICTS

* * * * *

211. Suitability

(a) through (b) No Change.

••• **Supplementary Material:** -----

.01 through .02 No Change.

.03 Regulation Best Interest. This Rule shall not apply to recommendations subject to SEA Rule 151-1 (“Regulation Best Interest”).

* * * * *