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Elizabeth M. Murphy
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File Number SR-FINRA-2010-039

Dear Ms. Murphy:

We are writing to comment on FINRA's Proposed Rules 2090 and 2111, which would supplant NYSE Rule 405 and NASD Conduct Rule 2310, respectively, in the Consolidated FINRA Rulebook. We are law professors who have written and lectured widely about the obligations of broker-dealers to their customers. We also have represented investors in securities arbitrations who have alleged violations of NASD Conduct Rule 2310. We filed comments with the FINRA on its prior version of the Proposed Rules ("June 29, 2009 FINRA comment letter").

NYSE Rule 405(1) currently requires NYSE members and their principals to "use due diligence to learn the essential facts relative to every customer…," creating the "Know Your Customer" obligation. NASD Conduct Rule 2310, also known as the Suitability Rule, imposes on members and associated persons the duty to make only suitable recommendations to customers and is an aspect of FINRA Rule 2010's requirement that members and associated persons observe "high standards of commercial honor." Therefore, we support the concept of incorporating NYSE Rule 405(1) and NASD Rule 2310 into the Consolidated FINRA Rulebook, as well as codifying various interpretations regarding the scope of the Suitability Rule. In particular, we support the language clarifying that the obligation encompasses investment strategies and delineating the three suitability obligations (reasonable basis, customer-specific and quantitative). However, we do not believe that the Proposed Rules go far enough to protect retail customers who increasingly must rely on investment professionals for critical and complex investment decisions. Accordingly, we make the following suggestions, many of which we previously made in our June 29, 2009 FINRA comment letter.

Know Your Customer – Proposed Rule 2090

In our June 29, 2009 FINRA comment letter we expressed concern over the choice of the word "essential" in the second line of the proposed rule, as the word used in this context can mean "barebones." We continue to be concerned, particularly since the modification of proposed Supplementary Material .01 may suggest a narrow scope of the

broker-dealer's obligation to know its customers. We agree with FINRA that the " 'know your customer' obligation should remain flexible and that the extent of the obligation generally should depend on a particular firm's business model, its customers, and applicable regulations." For example, we believe that full-service broker-dealers whose registered representatives customarily make recommendations to their customers must know their customers' financial profiles and investment objectives; this responsibility, however, may not extend to discount brokers that only execute orders on behalf of their customers. Accordingly, we suggest revising the proposed Supplementary Material to read as follows (proposed language underlined):

.01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" include, at a minimum, those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.

We believe this change is more consistent with FINRA's objective to be flexible and "less prescriptive." We do not think that FINRA should limit "essential facts" to those specifically set forth in Supplementary Material .01.

Suitability – Proposed Rule 2111

Because FINRA did not request comment on whether fiduciary obligations should influence the suitability proposal, we did not address this issue in our June 29, 2009 FINRA comment letter. We continue to believe that the comment process on Proposed Rule 2111 is not the appropriate occasion for this discussion, since the SEC has called for public comment on this issue.[1] We do wish to express our disagreement with the view expressed by some commenters that FINRA should defer adoption of the proposed suitability rule "until after policymakers (e.g., Congress, the SEC, and/or FINRA) determine whether broker-dealers must comply with fiduciary obligations." While Dodd-Frank requires the SEC to complete its study of the obligations of broker-dealers and investment advisers within six months, the statute does not mandate any SEC rulemaking on the issue. Accordingly, it does not make sense to delay adoption of the proposed suitability rule because of the possibility that the SEC, at some future time, may determine to propose its own rules with respect to broker-dealers' obligations. This is particularly the case since, as FINRA notes, the suitability obligation is a well-recognized standard already applicable to both broker-dealers and investment advisers, the latter under an explicit fiduciary duty standard.

Scope of the Suitability Rule/Non-Securities Products

We are disappointed that FINRA declined to expand suitability obligations explicitly to include recommendations of all investment products, services and strategies made in connection with a firm's business, regardless of whether the recommendations

[1] *See* SEC Press Rel. 2010-134, SEC Publishes Public Request for Comment to Inform Study of Obligations of Broker-Dealers and Investment Advisers (July 27, 2010).

involve securities. FINRA stated it did not agree with the reasoning of those commenters who objected to the expansion, "with the possible exception of potentially duplicative regulation, which FINRA believes could be addressed in any further expansion of the reach of the rule." Rather, FINRA's reasons for its decision are that "future developments in regulatory restructuring could impact any such proposal" and that its other proposed rule changes enhance investor protection. Yet, as noted above, FINRA rejected the argument that it should not adopt any form of a revised suitability rule because of possible future regulation pursuant to Dodd-Frank. Similarly, we assert that the possibility of "future developments in regulatory restructuring" is not an adequate reason to defer adoption of a suitability rule that would provide additional and much needed protection for investors. Increasingly, broker-dealers offer their customers a variety of financial products; in addition, many broker-dealers permit their associated persons to offer their customers financial products as private securities transactions pursuant to NASD Rule 3040 or outside business activities pursuant to NASD Rule 3030. Because of this, we do not believe that the proposed rule provides adequate protection for investors, for the following reasons.

First, in some instances it may be unclear whether the product is a security as defined in the federal securities laws.[2] Associated persons have marketed many types of schemes, including promissory notes, prime bank schemes and ponzi schemes, to the public, based on promoters' assertions that these schemes did not involve securities.[3]

Second, because financial products have become more complex and difficult for many customers to understand, customers of necessity have come to rely on their brokers' advice for investments and strategies that meet their financial situation and investment objectives. For example, in the wake of an earlier downturn in the equity markets, NASD observed that brokers and retail investors showed increased interest in non-conventional investments (NCIs) that frequently have complex terms and features. It reminded its members that "the fact that an investment is a NCI does not in any way diminish a member's responsibility to ensure that such a product is offered and sold in a manner consistent with the member's general sales conduct obligations."[4]

Finally, and most fundamentally, members and associated persons fail to observe the "high standards of commercial honor and just and equitable principles of trade" required by FINRA Rule 2010 if they recommend any unsuitable financial product, service or strategy to their customers. NASD and FINRA have long recognized that sales efforts must be judged by the Rules' ethical standards, "with particular emphasis on the

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[2] *See, e.g.*, Complaint, Amer. Equity Life Ins. Co. v. SEC, Case No. 09-1021 (D.C. Cir.) (challenging SEC's adoption of a rule regulating indexed annuities); SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996) (holding that viatical settlements were not securities under federal law).

[3] *See* NASD NOTICE TO MEMBERS 01-79 (NASD Reminds Members of Their Responsibilities Regarding Private Securities Transactions Involving Notes and Other Securities and Outside Business Activities) (Dec. 2001).

[4] NASD NOTICE TO MEMBERS 03-71 (Non-Conventional Investments) (Nov. 2003).

requirement to deal fairly with the public."[5] Thus, for example, in 2005 NASD expressed concern about the manner in which associated persons were selling unregistered equity-indexed annuities (EIAs) and the absence of adequate supervision of these sales practices.[6] Without seeking to resolve the issue of whether any particular EIA was an insurance product or a security, NASD emphasized that because of the complexity of EIAs a broker may have difficulty determining whether the features of any particular product were suitable for his customer. Accordingly, it encouraged firms to adopt supervisory procedures to protect their customers, including supervision over the suitability analysis and other sales practices associated with the recommendation of unregistered EIAs in the same manner that it supervises the sale of securities. More recently, Richard G. Ketchum, Chairman and CEO of FINRA, has stated that "[i]t has long been urged by FINRA—and it is a personal mission of mine—that America's 90 million investors should receive the same level of protection no matter which financial services or products they select."[7]

In short, a broker is not dealing fairly with his customer if he makes a recommendation of any product, service or strategy without having a reasonable basis to believe, based on appropriate due diligence, that the recommendation is suitable for his customer. We are disappointed that FINRA chose not to revise proposed Rule 2111(a) to incorporate explicitly a suitability obligation that is not limited to securities. Such a revision is not, in our view, an *expansion* of the brokers' obligations; rather it would make explicit what the SRO Rules have consistently required from members and associated persons.

Information Gathering/Information Known by the Firm

In our June 29, 2009 FINRA comment letter we expressed concern that the use of the phrase "based on facts *known* by the member firm or associated person" left a loophole for associated persons to claim they did not know certain information when they consciously avoided learning it. The current proposed substitution of a "reasonable diligence" standard is thus an improvement. However, we believe that the proposed language still has two major loopholes. First, the information is specifically limited to that obtained through reasonable diligence "to ascertain the customer's investment profile," thus creating the possibility of an assertion that the information was obtained for some other purpose. Second, "any other information the customer may disclose…in

[5] IM-2310-2 (Fair Dealing with Customers).

[6] NASD NOTICE TO MEMBERS 05-50 (Equity-Indexed Annuities) (Aug. 2005); *see also* NASD Rule 2212(g)(2) (Telemarketing) (regulating any telephone solicitations "for the purpose of encouraging the purchase or rental of, or investment in, property, goods or services").

[7] *See* Rick Ketchum, Remarks at the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at http://www.finra.org/Newsroom/Speeches/Ketchum/P118889; *see also* Rick Ketchum, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Mar. 26, 2009) (stating that "at the very "least, our system should provide investors with the following protections: … every product marketed to a particular investor is appropriate for recommendation to that investor"), available at http://www.finra.org/Newsroom/Speeches/Ketchum/P118298.

connection with such recommendation" is similarly too limited. We strongly believe that the suitability determination must be based on all information that the broker-dealer or associated person knows, or should know, whatever the reason for acquiring it.

Failure to Include NASD 2310 Interpretive Material

We continue to be concerned that the proposal eliminates some of the current 2310-2 Interpretive Material (IM) rather than transferring that material into the Consolidated FINRA Rulebook with Proposed Rule 2111. FINRA justifies this elimination on the ground that "most of the current IMs following NASD Rule 2310 … are no longer necessary" as either duplicative or moot.

We strenuously disagree with FINRA's view that the eliminated IMs are "no longer necessary." For example, IM 2310-2 explains to members that FINRA can discipline them for improper sales practices and gives specific examples of common types of broker misconduct, including excessive trading, unauthorized trading, and fraud. This interpretive material is the only place in the NASD Conduct Rules explicitly prohibiting unauthorized trading and has been the basis of enforcement actions for unauthorized trading.[8] Including some, but not all, of the examples of improper sales practices in the new Rule and Supplementary Material may suggest that the excluded practices are no longer considered improper. While FINRA states that "the elimination of the discussion of unauthorized trading in the IMs following the suitability rule in no way alters the longstanding view that unauthorized trading clearly violates FINRA's rules," the omission of this IM in the Consolidated FINRA Rulebook, whether as part of Proposed FINRA Rule 2111 or with FINRA Rule 2010 (as examples of violations of the rule requiring that members observe just and equitable principles of trade in the conduct of its business), only diminishes the clarity that the IM provides to members. Accordingly, we believe it is important for investor protection to retain the IMs following current NASD Conduct Rule 2310 into the Consolidated FINRA Rulebook.

Thank you for the opportunity to make these comments.

Sincerely,

Jill Gross

Barbara Black

[8] *See* In the Matter of the Dept. of Enforcement vs. Baxter, 2000 WL 535170 (N.A.S.D. Apr. 19, 2000) (affirming sanction against associated person for unauthorized trading under IM 2310-2).