SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-88422; File No. SR-FINRA-2020-007)

March 19, 2020

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 March 12, 2020, 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 Regulation Best Interest ("Reg BI"),[3] and to remove the element of control from the quantitative suitability obligation; and (2) conform the rules

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 17 CFR 240.15l-1.

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 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

[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").

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 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.

---

5 See Release, 84 FR at 33318-33319.

6 See Release, 84 FR at 33400.

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 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]

---

7 See FINRA Rule 2111(a).

8 See FINRA Rule 2111.05.

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 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

---

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).

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

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), 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.

---

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 240.15l-1(b)(1).

14 See proposed FINRA Rule 2111.05(c).

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;
- 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

[15] See proposed CAB Rule 211.03.

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 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

---

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 240.15l-1(a)(2)(iii)(D).

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

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 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

[19] 15 U.S.C. 78o–3(b)(6).

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 [sic] as Exhibit 2a. Copies of the comment letters received in response to the Notice are attached [sic] 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

---

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

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

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 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.

---

22 See NASAA.

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

24 See FSI; PIABA; SER.

25 See Cambridge; Capital Forensics; Keesal; SIFMA.

26 See FSI.

27 See Cambridge; Keesal; SIFMA.

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:

(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]

J. Matthew DeLesDernier
Assistant Secretary

[28] 17 CFR 200.30-3(a)(12).