

Regulatory Notice

20-18

Reg BI-Related Changes to FINRA Rules

FINRA Amends Its Suitability, Non-Cash Compensation and Capital Acquisition Broker (CAB) Rules in Response to Regulation Best Interest

Effective Date: June 30, 2020

Summary

FINRA has amended its suitability rule, Capital Acquisition Broker (CAB) suitability rule and rules governing non-cash compensation to provide clarity on which standard applies and to address potential inconsistencies with the Securities and Exchange Commission's (SEC's) Regulation Best Interest (Reg BI).¹ These changes have been approved by the SEC and become effective on June 30, 2020, the compliance date of Reg BI.

The text of the amended rules is set forth 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 jim.wrona@finra.org;
- ▶ Joseph P. Savage, Vice President, OGC, at (240) 386-4534 or joe.savage@finra.org; or
- ▶ Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018 or meredith.cordisco@finra.org.

Discussion

On June 5, 2019, the SEC adopted Reg BI under the Securities Exchange Act of 1934 (Exchange Act).² Reg BI establishes a "best interest" standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities, including recommendations of types of accounts. Among other things, Reg BI incorporates and enhances principles that are also found in FINRA Rule 2111 (Suitability). To provide clarity over which standard applies, FINRA has amended its suitability rule to state that Rule 2111 does not apply to recommendations that are subject to Reg BI.

June 19, 2020

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management

Key Topics

- ▶ Best Interest Standard of Conduct
- ▶ Non-Cash Compensation
- ▶ Suitability

Referenced Rules & Notices

- ▶ CAB Rule 211
- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2310
- ▶ FINRA Rule 2320
- ▶ FINRA Rule 2341
- ▶ FINRA Rule 5110
- ▶ Regulation Best Interest
- ▶ Securities Exchange Act of 1934

Reg BI also 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. To avoid potential inconsistencies, FINRA has amended its non-cash compensation rules to provide that the practices addressed by those rules also must be consistent with Reg BI.

Suitability

FINRA Rule 2111 requires, in part, that a broker-dealer or associated person “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 firm or associated person to ascertain the customer’s investment profile.” The rule identifies the three main suitability obligations: reasonable-basis, customer-specific and quantitative suitability.

Reg BI’s Care Obligation addresses the same conduct with respect to retail customers that is addressed by Rule 2111, but employs a best interest, rather than a suitability, standard, in addition to other key enhancements. 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, 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.

To provide clarity on which standard applies and to avoid unnecessary duplication, FINRA has amended Rule 2111 to state that it will not apply to recommendations subject to Reg BI.³ FINRA has also removed the element of control from the quantitative suitability obligation, a change that is consistent with Reg BI.⁴ Finally, FINRA has conformed the CAB suitability rule, CAB Rule 211, to the amendments to Rule 2111.

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.⁵

As noted above, 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.⁶ To avoid any potential inconsistency between the FINRA non-cash compensation rules and Reg BI’s limitations in this area, FINRA has amended its rules to ensure that the arrangements addressed must also be consistent with the applicable requirements of Reg BI.⁷

Endnotes

1. See Securities Exchange Act Release No. 89091 (June 18, 2020) (Order Granting Approval of File No. SR-FINRA-2020-007).
2. 17 CFR 240.15/-1. See Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019) (Reg BI Release).
3. See FINRA Rule 2111.08. FINRA has not eliminated its suitability rule because there will be recommendations that will not be subject to Reg BI but that would still warrant suitability protections. For example, before these changes, FINRA Rule 2111 applied broadly to all recommendations to customers (albeit with an exemption to customer-specific suitability for recommendations to institutional customers under specified circumstances). 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. See 17 CFR 240.15/-1(b) (1). 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, other FINRA rules that have a suitability or suitability-like component (e.g., FINRA Rule 2330 (Members’ Responsibilities Regarding Deferred Variable Annuities) and FINRA Rule 2360 (Options)) are not impacted by these rule changes and remain in place.
4. See Reg BI Release, 84 FR at 33384.
5. As a general matter, these rules limit non-cash compensation arrangements to: (1) gifts that do not exceed \$100 in value and that are not preconditioned on the achievement of a sales target; (2) 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; (3) 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 (4) internal non-cash compensation arrangements between a member and its associated persons, subject to specified conditions. If the internal noncash compensation arrangement is in the form of a contest in connection with the sale and distribution of variable insurance contracts or investment company securities, the contest must be based on the total production of associated persons with respect to all securities within those product categories, and credit for those sales must be equally weighted. See FINRA Rules 2320(g)(4)(D) and 2341(l)(5)(D). Rules 2310(c)(2)(D) and 5110(h)(2)(D) do not require internal non-cash compensation arrangements in connection with the sale and distribution of direct participation programs or public offerings of securities to be based on total production and equal weighting of securities sales.
6. See 17 CFR 240.15/-1(a)(2)(iii)(D).
7. See FINRA Rules 2310(c)(2), 2320(g)(4), 2341(l) and 5110(h)(2). The purpose of these amendments is to ensure that these rules’ limits on non-cash compensation are read consistently with the SEC staff’s interpretations of Reg BI, including in particular paragraph (a)(2)(iii)(D).

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, 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 15l-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 15l-1 ("Regulation Best Interest") and are limited to the following:

(A) 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 15l-1 ("Regulation Best Interest"):

(A) through (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 15l-1 ("Regulation Best Interest"):

(A) through (E) No Change.

(m) through (n) No Change.

* * * * *

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 15l-1 ("Regulation Best Interest") and are limited to the following:

(A) through (E) No Change.

(i) No Change.

* * * * *

CAPITAL ACQUISITION BROKER RULES

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 15l-1 (“Regulation Best Interest”).