

14 December 2009

Eddy Wymeersch, Chairman
Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris, France

Subject: Comments on Consultation Paper, *Understanding the definition of advice under MiFID*

Dear Mr. Wymeersch:

The Financial Industry Regulatory Authority, Inc. (FINRA) appreciates the opportunity to address the Committee of European Securities Regulators' Consultation Paper on Understanding the Definition of Advice under the Markets in Financial Instruments Directive (MiFID). Under MiFID, the term "investment advice" means "the provision of personal recommendations to a client, either upon the client's request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments." For purposes of that definition, the recommendation must be presented as suitable for that person or must be based on a consideration of the circumstances of that person.

Although the regulatory approach taken by FINRA in this area is somewhat different, our experience over the years has caused us to grapple with many of the same practical issues that CESR seeks to address in its consultation paper. Based on that experience, FINRA is pleased to offer some general comments that CESR might find helpful as it finalizes its guidance on the definition of investment advice.

For approximately 70 years, FINRA has imposed suitability obligations on its member firms. FINRA's suitability rule attempts to neutralize the potential conflict of interest in the broker-customer relationship. (See Rule 2310). The rule also implicitly recognizes that customers may rely on a broker's special investment skills and knowledge, and it is thus appropriate to hold brokers responsible for the recommendations that they make to customers. In light of these goals, FINRA's suitability rule applies only when a broker *recommends* a security or investment strategy. Whenever a broker makes a recommendation, he or she *must* have reasonable grounds for believing that the recommendation is suitable for the customer based on that customer's profile (e.g., the customer's other security holdings, financial situation and needs, investment objectives).¹ If the broker has not made a recommendation—for example, where a broker acts solely as an order taker - the suitability rule does not apply.

¹ There are three main suitability obligations: reasonable-basis suitability, customer-specific suitability and quantitative suitability. The reasonable-basis obligation requires a broker to have a reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for at least *some* investors. The customer-specific obligation requires that a broker have reasonable grounds to believe that the recommendation is suitable for a particular customer based on that customer's profile. Quantitative suitability requires a broker 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 profile.

Notwithstanding the significance of the term, FINRA purposely has not defined “recommendation.” The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case. FINRA believes that maintaining such flexibility is important and that, under its regulatory scheme, defining the term would not necessarily be helpful in light of the many variables involved in the analysis. In 2001, however, FINRA announced several guiding principles regarding whether a particular communication constitutes a recommendation for purposes of the suitability rule. *See Notice to Members 01-23 (April 2001) (copy attached).*

FINRA stated that a communication’s content, context, and presentation are important aspects of the inquiry. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or strategy, the more likely it is that the communication will be viewed as a recommendation. In this respect, a research report, standing alone, ordinarily would not be viewed as a recommendation under the FINRA suitability rule because it is not an individualized communication that takes into consideration a customer’s particular financial situation or needs. FINRA explained, however, that a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate.

FINRA also stated that it makes no difference whether the communication was initiated by a person or a computer software program. A brokerage firm, for example, could provide an automated portfolio analysis tool on its Website that allows a customer to indicate an investment goal and enter personalized information such as age, financial condition, and risk tolerance. If the automated tool then sends or displays to the customer a list of specific securities the customer could buy or sell to meet the investment goal, the tool likely would be making a recommendation that triggers suitability obligations for the originating firm.

FINRA also made clear that a broker’s subjective filtering or manipulation of information can lead to a finding that a communication is a recommendation. FINRA’s guidance focused on automated research tools that allow customers to scan a wide universe of securities and to request lists of securities that meet broad, objective criteria (e.g., all companies in a particular sector with a certain percentage of annual earnings growth). If the brokerage firm imposes limits on the manner in which the research tool searches through a wide universe of securities or controls the generation of the list to favor certain securities, it is likely that the presentation would be viewed as a recommendation under the suitability rule.

Finally, FINRA noted the relevance of determining whether a reasonable person would view the communication as a recommendation. Thus, for example, FINRA explained that a broker could not avoid suitability obligations through a disclaimer where—given its content, context, and presentation—the particular communication reasonably would be viewed as a recommendation.

These guiding principles, together with numerous litigated decisions and the facts and circumstances of any particular case, inform the determination of whether the communication is a recommendation for purposes of FINRA’s suitability rule. Accordingly, FINRA members now have a fundamental understanding of what communications likely do or do not constitute recommendations. At the same time, the “facts and circumstances” approach does not statically place particular categories of communications on different sides of the equation and positions the suitability rule to more easily evolve with technological developments.

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We trust that this brief analysis provides some insights that will contribute to CESR's efforts to clarify the meaning of investment advice under MiFID.

Sincerely,

A handwritten signature in black ink, appearing to read 'Marc Menchel', written in a cursive style.

Marc Menchel
Executive Vice President and General Counsel