

Feltl and Company
SECURITIES BROKERAGE AND INVESTMENT BANKING

COMPLIANCE ALERT

2012-03

To: All Securities Licensed Personnel
From: F. Chet Taylor, General Counsel
RE: New FINRA Suitability Rule 2111 – Effective TODAY
Date: **Monday, July 9, 2012**

When we conducted our branch-by-branch annual compliance meetings last Fall, we discussed the new suitability rule (FINRA Rule 2111) that would be taking effect on July 9, 2012. Effective today, that new rule now governs your conduct with your customers. Please do not think of this new rule as simply “minor tweaks” to existing law. Rather, this new rule represents sweeping changes in the way you conduct your business. Understanding this new rule will be paramount to avoiding future disciplinary actions and lawsuits.

Attached is a copy of Rule 2111 for your review. Please read the rule in its entirety, including the “Supplementary Material” that appears just below the text of the rule. **This is required reading.** We also **strongly recommend** that you read FINRA Notices to Members Nos. 11-02, 11-25, and 12-25, which may be found on the FINRA website: www.finra.org. They contain detailed explanations of the rule and also contain very helpful Question & Answer sections.

The following is a summary of your duties and obligations under the new rule:

KNOW YOUR CUSTOMER

The amount of financial information required from customers has been expanded. NFS updated the new account form in August 2011 to meet the expanded requirement. If you have opened or updated a new account with this form, assuming your customer answered all questions, no further action is needed. If you have accounts opened before the above mentioned date and have yet to update the account, you need to do so ASAP, but no later than December 31, 2012. Use this as a sales opportunity to get in touch with your customers and let them know that new regulations just went into effect that require the gathering of additional customer information. If customers refuse to provide the required financial information, you will not be able to solicit anything but conservative investments, such as CDs, Treasuries, and A-rated bonds.

Not only must you gather financial information, you must also USE that information when making recommendations to your customers. The days of conforming your customers’ investment objectives to meet your recommendations are long gone. Instead, you must conform your recommendations to meet your customers’ investment objectives. Regulators will be highly suspicious if all of your customer

accounts are invested the same way. You are the investment professional, and you are expected to tailor your recommendations to the needs of each individual customer.

Under the new rule, this duty to determine suitability applies not only to recommendations to buy and sell investments, but it also now applies to **investment strategies** AND to **“Hold” recommendations**. To be clear, “silence” with regard to a particular investment is not a Hold recommendation. To be considered a “Hold” recommendation the broker must explicitly advise the customer to hold some or all of a position.

Finally, the new suitability rule specifies that the **quantity** of an investment must be suitable. That is, a purchase of 100 shares of XYZ Corp. might very well be suitable for a particular customer, whereas 1,000 shares of that same stock might not be suitable for that customer. Please pay attention to how much of an investment, or an investment class, that a customer owns before recommending further purchases. Over concentration in a particular stock, industry, or risk category will always invite regulatory scrutiny. Well-diversified accounts, on the other hand, often provide a higher degree of protection, not only for the customer, but for you as well.

The best method to demonstrate compliance with this rule is documentation. We recommend that you document all of your recommendations, preferably through a secure software program, such as Brokers Ally. Not only could this better protect you from disciplinary actions and customer complaints, documentation is vital when making Hold recommendations. With Hold Recommendations there will be no paper trail unless you create one. Attached is a “Hold Log” that you may use if you choose not to invest in software – but we still highly recommend the software. If you ever have a problem, the cost of the software could pay for itself many times over.

KNOW YOUR INVESTMENT

The new rule makes it very clear that before recommending any investment, you personally must have a reasonable basis to believe that the investment itself is suitable. That is, you must perform sufficient due diligence to satisfy yourself that (i) you understand the business of the company you are recommending; (ii) you know the company’s current financial condition; (iii) you understand the potential risks and rewards involved in the investment; and (iv) you have a reasonable basis for your belief that the future prospects of the company are promising. You should maintain a due diligence file on every investment recommendation that you make. This file should be available for review at any time by your Branch Office Manager and/or Compliance Officer.

The Firm will recognize the retention of F&C’s Research Department reports as suitable material for establishing a due diligence file – though it is still your obligation to understand the security as well as make sure that the investment is suitable for your particular customer. If you are recommending any investments that aren’t followed by F&C’s Research Department, you must acquire your own due diligence materials for your file.

YOU MAY NOT SOLICIT THE PURCHASE OF ANY OTC STOCK - “PENNY STOCK RULE” (i.e., Bulletin Board or Pink Sheets), unless Compliance has approved a specific exception for that stock. Typically, Compliance will only approve exceptions if there is Corporate Finance relationship with the company that allows us to satisfy our due diligence obligations (such as Sajan, Inc. and Black Ridge Oil & Gas) AND/OR the security qualifies for an exemption from the Penny Stock rules due to revenue or assets.

We are creating a form to request such an exception and it should be available by the end of this week. Compliance approval in no way limits the Registered Representative's responsibility to maintain the proper due diligence file as required by Rule 2111 for all solicited investments.

If you have a customer who desires to make an unsolicited purchase of an OTC stock or penny stock, he/she may only do so by filling out and signing a copy of our "Unsolicited Letter" in advance of the trade. A copy of the current version of that letter is attached and appears on F&C's website – please don't use older versions. **There will be no exceptions!**

YOU MAY NOT SOLICIT THE PURCHASE OF ANY PRIVATE PLACEMENT unless it is either underwritten by F&C, or has been approved for sale by F&C's Corporate Finance Department.

BEFORE SOLICITING THE PURCHASE OF ANY "SPECIALTY PRODUCT," PLEASE MAKE SURE IT HAS BEEN APPROVED FOR SALE. If you intend to recommend the purchase of investments such as annuities, other insurance products, REITs, or direct mutual funds (i.e., not through Streetscape), please contact Melanie dePalma to make sure that the product has been approved for sale.

Feel free to contact me with any questions you might have about the new suitability rule and F&C's new requirements. Thanks for your attention and anticipated cooperation.



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2111. Suitability

This rule was introduced with the filing of SR-FINRA-2010-039 which has been approved by the SEC. This rule becomes effective on July 9, 2012.

(a) A member or an associated person must 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. 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.

(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in [Rule 4512\(c\)](#), if (1) the member or associated person has 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 and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

• • • Supplementary Material: -----

.01 General Principles. Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA's rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

.02 Disclaimers. A member or associated person cannot disclaim any responsibilities under the suitability rule.

.03 Recommended Strategies. The phrase "investment strategy involving a security or securities" used in this Rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities. However, the following communications are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities:

(a) General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile;

(b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

(c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with NASD [IM-2210-6](#) (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD [IM-2210-6](#); and

(d) Interactive investment materials that incorporate the above.

.04 Customer's Investment Profile. A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe,

documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.

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

(a) The reasonable-basis obligation 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. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

(b) The customer-specific obligation 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, as delineated in Rule 2111(a).

(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 Customer's Financial Ability. Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities unless the member or associated person has a reasonable basis to believe that the customer has the financial ability to meet such a commitment.

.07 Institutional Investor Exemption. Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions delineated in that paragraph are satisfied. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.

Adopted by SR-FINRA-2010-039 and amended by SR-FINRA-2011-016 and SR-FINRA-2012-027 eff. July 9, 2012.

Selected Notices: [11-02](#), [11-25](#), [12-25](#).

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SECURITIES BROKERAGE AND INVESTMENT BANKING

UNSOLICITED LETTER OF TRANSACTION

Feltl and Company
800 LaSalle Ave, Suite 2100
Minneapolis, MN 55402

Dear Compliance Department:

The purpose of this letter is to confirm my purchase of _____ shares of _____ through my broker _____ was initiated at my request and was not directly or indirectly solicited or recommended by my broker. **I understand that investing in low-priced securities is a high-risk investment strategy and that I could lose my entire investment.** I am willing to assume those risks.

Sincerely,

Signature Date Account #

Signature (If Joint) Date

I hereby agree with the above statement:

I.E. Signature Date I.E. #