

MEMO# 24500

August 18, 2010

SEC Publishes For Comment FINRA's Proposed Revisions To Suitability And "Know Your Customer" Rules; Comments Due To ICI August 27th

[24500]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 34-10
COMPLIANCE MEMBERS No. 18-10
TRANSFER AGENT ADVISORY COMMITTEE No. 47-10 RE: SEC PUBLISHES FOR COMMENT
FINRA'S PROPOSED REVISIONS TO SUITABILITY AND "KNOW YOUR CUSTOMER" RULES;
COMMENTS DUE TO ICI AUGUST 27TH

In May 2009, as part of its process to consolidate the NASD's and NYSE's rules, FINRA published for comment its proposed consolidation of the rules governing suitability and "know your customer." [\[1\]](#) In June 2009, the Institute filed a comment letter with FINRA on its proposal. [\[2\]](#) The Institute's letter supported the proposal, but recommended that it be revised to retain an exception for money market mutual funds that had been in the suitability rule since its original adoption almost twenty years ago and which FINRA had proposed to delete in the revised rule. Our letter also recommended that FINRA clarify in the Supplementary Material to the proposed rule that suitability determinations remain the province of the FINRA member.

After reviewing and considering the 2000+ comments filed on the proposal, FINRA filed a revised version with the Securities and Exchange Commission for adoption. The Commission has published the revised proposal, which is briefly summarized below, for comment. [\[3\]](#) The Institute expects to file a comment letter supporting its adoption and reiterating our recommendation that the exception for money market mutual funds be retained.

Comments on the proposal are due to the SEC 21 days from the proposal's publication in

the Federal Register, which is expected shortly. If you have comments on the proposal you would like the Institute to consider including in our comment letter, please provide them to the undersigned by phone (202-326-5825) or email (tamara@ici.org) no later than Friday, August 27th.

Summary of FINRA's Proposed Consolidated Suitability Rule 2111

Much of FINRA's original proposal is retained in the current version. Indeed, the most substantive changes were made to the portion of the rule relating to the customer-specific suitability obligations for an institutional customer. In addition, however, the information to be considered in making a suitability determination or under "know your customer" obligations has been somewhat narrowed to address commenters' concerns.

As with the original proposal, the new rule, proposed Rule 2111, would consist largely of a revised version of NASD Rule 2310. In lieu of the existing Interpretive Materials ("IMs"), the new rule would be followed by "Supplementary Material" addressing "General Principles" (.01); "Components of Suitability Obligations" (.03); and "Customers' Financial Ability (.04)." Added to the Supplementary Material, however, would be two additional provisions: "Recommended Strategies" (.02) and "Institutional Investor" (.05).

Unlike the existing NASD rule and IMs, the new rule would:

- Expand the application of the suitability requirements to include recommendations relating to investment strategies involving a security or securities. The new "Recommended Strategies" Supplementary Material would both clarify that this provision "is to be interpreted broadly," and list various types of informational materials that would be excluded from the rule's coverage (e.g., general financial and investment information that does not recommend a particular security);
- Add to the list of information that must be taken into account in determining suitability: the customer's investment experience, investment time horizon, liquidity needs, and risk tolerance. While FINRA's proposal had also included in this list "any other information the member or associated person considers to be reasonable in making recommendations," this provision has been replaced "any other information the customer may disclose to the member or associated person in connection with such recommendation;"and
- Revise the definition of "institutional customer" to which the suitability requirement applies. In particular, currently, IM-2310-3 defines "institutional customer" as an entity other than a natural person and notes that such guidance is "more appropriately applied to an institutional customer with at least \$10 million invested in securities." Proposed Rule 2111 would apply the new suitability requirements to any institutional account "as defined in NASD Rule 3110(c)(4)," which would include natural persons and entities with total assets of at least \$50 million. [\[4\]](#)

Institutional Investors

As mentioned above, the current version of FINRA's proposal differs significantly in its treatment of institutional investors from the prior version – though the definition of "institutional investor" is the same in both. The prior version had provided that a broker-dealer or associated person fulfills its customer-specific suitability obligation for an institutional account if, in part, "the institutional customer affirmatively indicates that it is

willing to forego the protection of the customer-specific obligation of the suitability rule.” This provision was revised in response to opposition by commenters. Under the current version, a FINRA member or its associate person would fulfill its customer-specific suitability obligations for an institutional account if:

1. It 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 associate person’s recommendations.

New Supplementary Material 05, “Institutional Investor,” would provide that the institutional investor may affirmatively indicate its exercise of independent judgment on either a trade-by-trade or asset-class-by-asset-class basis “or in terms of all potential transactions for its account.”

Proposed Supplementary Materials

In addition to proposed Supplementary Materials discussed above, additional Supplementary Material would accompany the new rule and replace the existing IMs as follows: [\[5\]](#)

.01 – General Principles: This would clarify that sales efforts must 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.

.03 – Components of Suitability Obligations: Currently, IM-2310-2, which relates to fair dealing with customers, addresses issues such as recommending speculative low-priced securities, excessive trading activities, short-term trading of mutual fund shares, fraudulent activities, recommending purchases beyond a customer’s capability, derivative products, and trades involving securities futures, index warrants, and hybrid securities. FINRA proposes to replace this detailed information with a more general provision that would establish “three main suitability obligations” under proposed Rule 2211. These three are: [\[6\]](#)

1. Reasonable basis suitability, which would require a member to have a reasonable basis to believe, based on “adequate due diligence,” that the recommendation is suitable “for at least some investors;” [\[7\]](#)
2. Customer-specific suitability, which would require the member or its associated person to have reasonable grounds to believe that the recommendation is suitable for a particular customer; and
3. Quantitative suitability, which appears to be a new term and obligation that would require 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 . . .”. According to this proposed Supplementary Material, while no single test would define excessive activities, factors that may provide a basis for finding a violation of the quantitative suitability obligation would include: the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer’s account.

.03 – Customer’s Financial Ability: This one sentence provision would clarify that Rule 2111

would prohibit recommendations that are “inconsistent with the reasonable expectation that the customer has the financial ability to meet such a commitment.”

FINRA Proposed Rule 2090, Know Your Customer

In addition to revising the suitability rule, FINRA’s previous and current proposal would also add a new Rule 2090, Know Your Customer. This new rule would consist of one sentence requiring FINRA members in opening and maintaining all accounts to use due diligence to know (and retain) essential facts concerning every customer and the authority of each person acting on behalf of such customer. It would be accompanied by Supplementary Material .01 clarifying the facts “essential” to “knowing the customer.” While the previous version of this Supplementary Material would have defined these essential facts to include the customer’s financial profile and investment objectives or policy, the current version replaces this with the facts required to:

- Effectively service the customer’s account;
- Act in accordance with any special handling instructions for the account;
- Understand the authority of each person acting on behalf of the customer; and
- Comply with applicable laws, regulations, and rules.

Treatment of Money Market Funds

As noted above, the Institute’s comment letter had recommended that the rule continue to include an exception for money market mutual funds from the requirement to make reasonable efforts to obtain additional information pertaining to customer accounts. According to the Release, FINRA declined to accommodate this request, noting that “FINRA believes that recommended money market funds should be subject to the same information-gathering requirements as other recommended securities. That is especially true in light of the problems experienced by the Reserve Primary Fund in late 2008.”

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endnotes

[1] See Institute [Memorandum](#) to Transfer Agent Advisory Committee No. 36-09, Broker/Dealer Advisory Committee No. 25-09, and Compliance Members No. 26-09 [No. 23476], dated May 21, 2009, which summarized FINRA Notice 09-25, Proposed Consolidated FINRA Rule Governing Suitability and Know-Your-Customer Obligations (May 2009).

[2] See [Memorandum](#) to Transfer Agent Advisory Committee No. 47-09, Broker/Dealer Advisory Committee No. 36-09, and Compliance Members No. 33-09 [No. 23476], [No. 23591] dated June 29, 2009, which summarized the Institute’s comment letter.

[3] See Securities and Exchange Commission Release No. 34-62718 (File No. SR-FINRA-2010-039) (August 13, 2010), which is available at: <http://www.sec.gov/rules/sro/finra/2010/34-62718.pdf>. The redlined version of the proposed rule can be found in Exhibit 5 to the Release at <http://www.sec.gov/rules/sro/finra.shtml>.

[4] NASD Rule 3010(c)(4) defines “institutional account” as the account of: a bank, savings and loan association, insurance company, registered investment company, registered investment adviser, or any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million. The rule’s definition of “institutional investor” remains unchanged from when FINRA published it for comment last year.

[5] According to the Release, “FINRA notes that supplementary material will be filed with the SEC and is enforceable to the same extent as the main rule text.” Release at p. 45.

[6] In response to previous public statements by FINRA staff that seemed inconsistent with the suitability rule’s requirements, the Institute’s comment letter had recommended that FINRA affirm that responsibility for analyzing the three elements lies with the member and not with FINRA. The Release and the current proposal do not address our recommendation.

[7] The only difference between the prior version of the provision and the current version is that “some” is italicized in the current version. Though “reasonable basis suitability” is not expressly mentioned in NASD Rule 2310, various NASD Notices to Members have discussed it as an obligation of broker-dealers. See NASD Notice to Members No. 04-30 (April 2004) (discussing reasonable basis suitability in connection with the sale of bonds and bond funds); NASD Notice to Members 03-07 (February 2003) (discussing reasonable basis suitability in connection with selling hedge funds); and Notice to Members 01-23 (April 2001) at n.4 (citing SEC proceedings finding a reasonable basis suitability obligation).

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