

MEMO# 23476

May 21, 2009

FINRA Proposes Revisions to the NASD's Suitability and "Know Your Customer" Rules

[23476]

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TO: TRANSFER AGENT ADVISORY COMMITTEE No. 36-09
BROKER/DEALER ADVISORY COMMITTEE No. 25-09
COMPLIANCE MEMBERS No. 26-09 RE: FINRA PROPOSES REVISIONS TO THE NASD'S
SUITABILITY AND "KNOW YOUR CUSTOMER" RULES

As part of its process to consolidate the NASD's and NYSE's rules, FINRA has published for comment its proposed consolidation of the rules governing suitability and "know your customer." [\[1\]](#) FINRA's proposal is briefly summarized below.

Comments on the proposal are due to FINRA by June 29th. If you have comments you would like the Institute to consider raising with FINRA, please provide them to the undersigned by phone (202)326-5825 or email (tamara@ici.org) no later than Friday, June 12th.

FINRA's Proposed Rule 2111, Suitability

Currently, suitability in connection with mutual fund transactions is governed by NASD Rule 2310, "Recommendations to Customers," which is supplemented by the following Interpretive Material (IM): IM-2310-2, "Fair Dealing with Customers," and IM-2310-3, "Suitability Obligations to Institutional Customers." As proposed by FINRA, the provisions of these rules and IM would be combined with NYSE Rule 405, which addresses know-your-customer obligations. The new rule, proposed Rule 2111, would consist largely of a revised version of NASD Rule 2310. In lieu of the existing IMs, the new rule would be followed by

“Supplementary Material” addressing “General Principles” (.01); “Components of Suitability Obligations” (.02); and “Customers’ Financial Ability (.03).” Unlike the existing NASD rule and IMs, the new rule and Supplementary Material would:

- Expand the application of the suitability requirements to include recommendations relating to investment strategies involving a security or securities;
- 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, risk tolerance, and “any other information the member or associated person considers to be reasonable in making recommendations;”
- Provide 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;” 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 have a \$50 million threshold. [\[2\]](#)

The Supplementary Material that would accompany the new rule and replace the existing IMs is as follows:

.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.

.02 – 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 more detailed information with a more general provision that would establish “three main suitability obligations” under proposed Rule 2211. These three are:

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;” [\[3\]](#)
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

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 that facts "essential" to "knowing the customer" include the customer's financial profile and investment objectives or policy.

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endnotes

[1] See FINRA Notice 09-25, Proposed Consolidated FINRA Rule Governing Suitability and Know-Your-Customer Obligations, FINRA Notice 09-25 (May 2009), which is available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8374.

[2] 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.

[3] 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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