New FINRA Rules on Knowing Your Customer and Suitability

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The Securities and Exchange Commission (SEC) recently approved two new Consolidated FINRA rules governing know-your-customer and suitability obligations of broker-dealers. Rule 2090 (Know Your Customer) and Rule 2111 (Suitability) will replace NYSE Rule 405 and NASD Rule 2310 as part of FINRA's ongoing effort to create a consolidated rulebook harmonizing former NASD and NYSE rules.

Broker-dealers will need to act quickly, as they must be in compliance with the new rules when they take effect on October 7, 2011. Prior to that, firms will need to take action to make sure their supervisory and compliance rules incorporate the rules and that associated persons are educated and trained on the new rules and any new firm procedures. This article introduces the key features of new FINRA rules 2090 and 2111 and also includes practice tips for complying with the new rules.

The new rules enlarge the scope of member firms' supervisory responsibilities by:

- Expanding the suitability obligations beyond transaction-based recommendations to now expressly include recommendations on "investment strategies"
- Creating a suitability obligation for a "recommendation to hold a security or securities"
- Expanding the factors that normally must be collected and analyzed as part of the "investor profile" to judge suitability
- Expressly incorporating three distinct suitability obligations: (a) reasonable-basis suitability, (b) customer-specific suitability and (c) quantitative suitability.

FINRA Rule 2090 ~ Know Your Customer

Rule 2090 is modeled after former NYSE Rule 405 and requires member firms to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer." The obligation arises at the beginning of the customer/broker relationship, independent of whether the broker-dealer has made any recommendation, and continues through termination of the relationship. Broker-dealers should take careful note of the new requirement to "retain" the "essential facts" concerning every customer.

According to Rule 2090's "Supplementary Material," "essential facts" are those facts that are 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
- Comply with applicable laws, regulations and rules

Essential facts for knowing the customer are defined when read in connection with Rule 2111's requirement that reasonable efforts be made to gather expanded categories of information about the customer's "investor profile" (discussed below) in order to evaluate suitability.

The new rule eliminates the requirement in NYSE Rule 405(1) that the firm/associated person learn the essential facts relative to "every order," deferring instead to existing order handling rules (i.e., FINRA Rule 5310 and NASD Rules 2320 and 2400).

Practical Aspects: The new rule raises the obvious question of what a firm should do with a prospective or current customer who refuses to provide "essential facts" – whether prior to a formal customer relationship or while the relationship is ongoing. Should the firm ignore or terminate the potential customer? Not necessarily. However, as discussed further below, if the broker-dealer cannot meet the reasonable-basis obligation under FINRA's new suitability rule due to an absence of necessary "essential facts" the broker-dealer may have no other option. Certainly, when the member and associated person must evaluate suitability under the new rule discussed below, such information may prove essential.

The best course of action is for the firm to carefully document the customer's refusal to provide the "essential facts" requested and the firm's efforts to obtain the "essential facts." Critically, as noted below, a firm must determine and record in writing why certain information which the customer refused to provide may not be relevant to the suitability analysis for the recommended investment transaction or strategy. Absent this written document and a clear reason, the firm servicing a person who refuses to give information runs the risk of having to defend the suitability of recommendations to the regulators.

FINRA Rule 2111 ~ Suitability

The suitability obligation in FINRA Rule 2111 is modeled after former NASD Rule 2310 (Suitability) and requires that a firm 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 member or associated person to ascertain the customer's investment profile." The rule offers an expanded list of relevant factors: 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."

FINRA Rule 2111 is notable for four reasons, addressed in detail below:

- It expands the suitability obligation beyond investment transactions to "investment strategies"
- It expands the suitability obligation to include explicit recommendations to hold securities
- It expands the necessary factors for making a suitability determination
- It includes definitions for three specific components of suitability evaluations

Suitability Obligation Now Extends to "Investment Strategies"

Unlike former NASD Rule 2310, which was limited to recommendations for the purchase, sale or exchange of any security, FINRA Rule 2111 expands the suitability obligation beyond just investment transactions to include "investment strategies." As a result, broker-dealers and associated persons must now think more broadly about what "strategy" has been recommended to the customer and whether it is suitable, and they must understand that their suitability obligations no longer begin and end with a specific transaction. The expanded suitability obligation for "strategies" also raises the question of whether brokers now must consider and recommend an overarching "strategy" for each of their customers, as opposed to simply providing advice on an order-by-order basis.

Nonetheless, the new supplementary material does exempt certain general, educational communications from Rule 2111 as not being considered "investment strategy," provided that they do not include a recommendation. These exempted communications include general financial and investment information discussing basic investment concepts, historical asset class returns, estimates of future retirement income needs, descriptive information about an employer-sponsored retirement plan, and asset allocation models based upon "generally accepted investment theory."

Suitability Obligation Now Extends to Recommendations to Hold Securities

Rule 2111's Supplementary Material includes "an explicit recommendation to hold a security or securities" within the phrase "investment strategy." Unclear is whether even advice to "stay the course" in the face of market fluctuation must pass muster under the FINRA suitability rule. Such would be a recommendation to hold securties, but would it be "an explicit recommendation" within the meaning of the rule? If so, this position is in stark contrast to the U.S. Supreme Court's decisions in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) and Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006) holding that there is no cause of action for "holder" claims. Presumably this big bite taken by FINRA will need to be clarified, as it seems like a stretch to think that general advice to "stay the course" and "not panic" is intended to give rise to completely new suitability analysis every time given.

Suitability Obligation Now Requires Determination of Customer's "Investor Profile"

FINRA Rule 2111 expands the factors an associated person is required to ascertain prior to making a recommendation to a customer. NASD's Rule 2310(b) required only "reasonable efforts" to obtain information concerning a customer's financial status, tax status, investment objectives and any such information "considered to be reasonable" in making a recommendation. Rule 2111 expands this requirement, mandating that the member/associated person "ascertain the customer's investment profile," including the following:

- Customer's age
- Other investments
- Financial status and needs
- Tax status
- Investment objectives
- Investment experience
- Investment time horizon
- Liquidity needs
- Risk tolerance
- Any other information the customer may disclose to the member or associated person in connection with such recommendation.

Moreover, as Supplementary Material to the Rule makes clear at paragraph .04, the above noted factors "generally are relevant" to suitability. A member or associated person must make reasonable efforts to obtain and analyze the factors unless they have "a reasonable basis to believe, documented in writing" that such omitted factor is not relevant to suitability. This is more exacting than the old test.

Broker-Dealers Must Now Satisfy Three Main Suitability Obligations

The supplementary material of the new suitability rule codifies the three components of a member/associated person's suitability obligations, expanding the prior rule's focus on a particular transaction.

- *Reasonable-Basis Suitability:* You can think of this as general product suitability. This obligation requires members through their associated persons to make an objective inquiry in whether there is "a reasonable basis to believe, based upon reasonable diligence, that the recommendation is suitable for at least some investors." The new rule explains that the level of necessary due diligence will vary with the complexity of the product and the associated person's familiarity with the security or investment strategy and requires that a member/associated person understand the potential risks and rewards associated with the recommendation.

- *Customer-Specific Suitability:* In addition to the objective requirement that the investment be reasonable in and of itself, this 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)." As noted above, Rule 2111 adds to the list of factors that must be considered in making the customer-specific determination.

  Concerning an institutional account as defined in NASD Rule 31109c)(4), the suitability obligation may be fulfilled if (1) there is a reasonable basis for believing that the institutional customer can independently evaluate investment risks independently (both generally and for specific transactions and strategies) and (2) the institutional customer affirmatively indicates (presumably in writing) it is using independent judgment in evaluating recommendations.

- *Quantitative Suitability:* This obligation is entirely new and is designed to combat churning. It might be thought of as "frequency of trading" suitability. The supplementary material requires an associated person who has "de facto" or actual 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." One suspects that FINRA will be likely to find "control" over the account where they think trading is excessive. Therefore, firms and associated persons should not have a false sense of security because no "discretionary" accounts are allowed.

Each of the above components of suitability requires the broker to exercise "reasonable diligence" in analyzing the suitability of the recommendation. Of course, that analysis need to be documented in a manner that can be examined by regulators and reproduced as evidence in customer arbitrations.

Practical Aspects: Rule 2111 raises a number of concerns that FINRA member firms must address by October 7, 2011, the effective date of the new rules. ***Firms should carefully consider what education of associated persons is necessary and what changes to existing forms and related supervisory and compliance procedures are required in light of the rules.***

To begin, firms need to consider what, in light of Rule 2111, an "investment strategy" is. Firms may consider looking at existing language contained in customer agreements and evaluating the clarity of the included investment objectives and risk tolerances. Such might be considered strategies subject to the new rules.

Now that FINRA intends to police hold recommendations, firms will also need to design and implement new supervisory guidelines to police such recommendations. This may require new surveillance techniques for supervisory personnel.. Almost certainly, firms will need to educate associated persons about the suitability standard applicable to any recommendation to hold a security.

In addition, firms must begin designing and implementing procedures to gather customer "investment profile" information. The firm may also need to reach out to existing customers to obtain additional information in order to meet the firm's suitability obligations going forward.

As if the above were not enough, firms should also consider how best to demonstrate to regulators that, with respect to each recommendation, they have considered all three components of a their suitability obligations.

Best practice will include educational compliance roll outs of these new FINRA rules to associated persons, explanation of same, and explanation of any new compliance procedures dealing with these suitability and know your customer rules.

In short, FINRA member firms must be proactive and begin designing and putting into operation new policies and procedures to ensure compliance with FINRA Rules 2090 and 2111.

Conclusion

FINRA's new know-your-customer and suitability rules do not simply recast existing NASD and NYSE rules. Rather, the new rules further define and expand a member/associated person's suitability obligations. Firms should not simply assume that their existing procedures address the suitability and know-your-customer obligations set forth in the new rules. Indeed, prior to October 7, 2011, the effective date of the new rules, firms should consider developing and implementing the supervisory procedures recommended above to ensure compliance with the new rules on the effective date.

If you would like to discuss the new FINRA rules, implementation of procedures to ensure compliance with those new rules, or any other securities law matter, please contact Gregory Kilby (616.752.2181 or gkilby@wnj.com), Mel Moseley (616-752-2177 or mmoseley@wnj.com) or any other member of the Securities Litigation and Arbitration Group at Warner Norcross & Judd.