SUTHERLAND

LEGAL ALERT

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Significant Changes to FINRA's Know Your Customer and Suitability Rules to Take Effect in 2011

On November 17, 2010, the Securities and Exchange Commission (SEC) approved two new FINRA rules: Rule 2090 (Know Your Customer) and Rule 2111 (Suitability) to replace NYSE Rule 405 and NASD Rule 2310. These rule changes are significant because they: 1) extend the suitability obligations from solely transaction-based recommendations to include investment strategy; 2) create a suitability obligation where a member/associated person makes "an explicit recommendation to hold a security or securities"; and 3) recognize three distinct suitability obligations: (a) a reasonable-basis suitability, (b) customer-specific suitability and (c) quantitative suitability. FINRA now must issue a Regulatory Notice announcing SEC approval. The implementation date of the new rules most likely will be the Fall of 2011.

Know-Your-Customer Rule (Rule 2090)

FINRA's new Rule 2090 encompasses many of the provisions contained in former NYSE Rule 405. The new rule 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 know-your-customer obligation arises immediately upon the opening of an account regardless of whether the broker has made a recommendation to the customer. 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 the specific order handling rules (such as FINRA Rule 5310, NASD Rules 2320, 2400). The new rule will delete former NYSE Rule 405(2) (Supervision of Accounts) and (3) (Approval of Accounts) as duplicative of other FINRA rules.

Suitability (Rule 2111)

FINRA's new suitability rule is notable for three reasons: 1) the revised rule covers investment strategies and explicit recommendations to hold securities; 2) it expands the necessary factors for making a suitability determination; and 3) it includes definitions for three specific suitability evaluations.

Suitability Review Expanded to Strategies, Including Explicit Recommendations to Hold

The current suitability rule, NASD Rule 2310, states, "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." The Rule thus requires a suitability analysis prior to recommending a purchase, sale or exchange.

FINRA's new suitability rule expands this obligation by requiring an associated person/member firm to undertake a suitability analysis prior to recommending a "transaction or **investment strategy involving a security or securities**." Supplementary material to the rule defines "investment strategy involving a security or securities" as including "an explicit recommendation to hold a security or securities." FINRA Conduct Rule 2111.03. The new Rule 2111 thus expands the obligation to cover an explicit hold recommendation. This is in stark contrast to the Supreme Court's decisions in <u>Blue Chip Stamps v.</u>

Manor Drug Stores, 421 U.S. 723 (1975) and Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006) that there is no right of action for "holder" claims.

The new supplementary material, however, exempts certain communications from Rule 2111 as not being considered "investment strategy." 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."

Finally, the supplementary material prohibits a member/associated person from recommending a transaction or investment strategy unless there is a reasonable basis to believe that the customer has the financial ability to meet the financial commitment. FINRA Conduct Rule 2111.06.

Expansion of Suitability Factors: "Investor Profile"

FINRA's new suitability rule likewise adds to the factors an associated person is required to ascertain prior to making a recommendation to a customer. NASD's Rule 2310(b) requires "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: 1) the customer's age, 2) other investments, 3) financial status and needs, 4) tax status, 5) investment objectives, 6) investment experience, 7) investment time horizon, 8) liquidity needs, 9) risk tolerance, and 10) any other information the customer may disclose to the member or associated person in connection with such recommendation. FINRA Conduct Rule 2111(a).

Three Specific Suitability Obligations

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

- Reasonable-Basis Suitability. This obligation requires members/associated persons to "have 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 amount of due diligence varies with the complexity of the product and the associated person's familiarity with the security or investment strategy and mandates that a member/associated person understand the potential risks and rewards associated with the recommendation. FINRA Conduct Rule 2111.05(a).
- Customer-Specific Suitability. In language similar to the current NASD Rule 2310(a), the supplementary material 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)." FINRA Conduct Rule 2111.05(b). As previously noted, the new rule adds to the list of factors that must be considered in making the customer-specific determination.
- Quantitative Suitability. This obligation is entirely new. "Quantitative suitability" essentially reflects existing case law relating to churning or excessive trading. See, e.g., O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 898 (10th Cir. 1992) (setting forth the elements of a churning claim). 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." FINRA Conduct Rule 2111.05(c).

Conclusion

The new rules further define and expand a member/associated person's suitability obligations. Prior to the effective dates of the new rules, most likely in the Fall of 2011, firms may want to consider whether to develop additional procedures to gather customer "investment profile" information and whether to memorialize that information in written form. Moreover, firms may want to consider whether and how to document conversations in which representatives discuss holding securities, because FINRA is now taking the position that explicit "hold" recommendations implicate the suitability rule.

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