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FINRA Proposes Changes to Know Your Customer and Suitability Rules

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On August 13, the Securities and Exchange Commission published a notice that the Financial Industry Regulatory Authority proposes to adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) as part of the Consolidated FINRA Rulebook. The proposed Know Your Customer and Suitability rules are based largely on the following:

- Incorporated NYSE Rule 405(1) (Diligence as to Accounts);
- NASD Rule 2310 (Recommendations to Customers (Suitability)); and
- both rules' related interpretative materials (together, the Existing Rules).

The proposed rules would delete the Existing Rules; however, the proposed rules seek to clarify and strengthen the core features of the Existing Rules.

Know Your Customer

The proposed Know Your Customer rules would impose the following obligations on broker-dealers in regards to the opening and maintenance of every account:

- to use "due diligence"; and
- to know the "essential facts" concerning every customer.

The proposed supplementary materials would define "essential facts" as those required to (a) effectively service the customer's account; (b) act in accordance with special handling instructions for the account; (c) understand the authority of each person acting on behalf of the customer; and (d) comply with applicable laws, regulations and rules.

These obligations would arise at the outset of the customer/broker relationship regardless of whether the broker has made a recommendation. Moreover, the proposed Know Your Customer rules would eliminate the existing requirement to learn the essential facts relative to "every order."

Suitability

The proposed Suitability rules would impose a reasonableness standard on broker-dealers in determining whether a transaction or investment strategy is suitable for a customer. This suitability assessment would require the broker-dealer to use reasonable diligence to ascertain the customer's investment profile. Relevant customer information would include, but would not be limited to, the following:

- age,
- other investments,
- financial situation and needs,
- tax status,
- investment objectives,
- investment experience,
- investment time horizon,
- liquidity needs, and
- risk tolerance.

The proposed Suitability rules explicitly cover the investment "strategy." While FINRA intends that "strategy" be interpreted broadly, the proposed Suitability rules expressly exclude the following communications, as long as they do not include a recommendation of a particular security:

- general financial and investment information, including (1) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return and tax deferred investment; (2) historic differences in the return of asset classes (e.g., equities, bonds or cash) based on standard market indices; (3) effects of inflation; (4) estimating future retirement income needs; and (5) assessment of a customer's investment profile;
- 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;
- asset allocation models that are (1) based on generally accepted investment theory, (2) 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 (3) 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
- interactive investment materials that incorporate the above.

The proposed Suitability rules also codify three interpretations of the reasonableness standard imposed on broker-dealers with respect to ensuring customer suitability:

- **Objective Reasonable Basis**—The broker-dealer must have a reasonable basis to believe, based on adequate due diligence, that a recommendation is suitable for at least some investors.

- **Customer-Specific/Subjective Reasonable Basis**—The broker-dealer must have reasonable grounds to believe a recommendation is suitable for the particular investor.
- **Quantitative Reasonable Basis**—The broker-dealer must have a reasonable basis to believe the number of recommended transactions within a certain period is not excessive.

Lastly, the proposed Suitability rules would amend the "institutional customer exemption." The Suitability rules center on whether there is a reasonable basis for the belief that an institutional customer is capable of assessing investment risk independently and whether the institutional customer is in fact exercising independent judgment.

To read the text of FINRA's proposed rule change, click here.

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