Broker-Dealer Know-Your-Customer and Suitability Obligations

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In January 2011, FINRA published Regulatory Notice 11-02, adopting rules governing the know-your-customer and suitability obligations of broker-dealers. What has changed and what, specifically, should broker-dealers be doing?

In July 2010, I wrote an article on FINRA Regulatory Notice 10-22, which was published as guidance to remind broker-dealers of their due diligence obligations in Regulation D offerings. Now, in a related pronouncement, FINRA has published FINRA Regulatory Notice 11-02, which consolidates and adopts new rules on the know-your-customer and suitability obligations (which also apply to Regulation D offerings), and continues the trend of increased scrutiny of broker-dealers in private placement offerings.

Know Your Customer – Reasonable Diligence and Essential Facts

New FINRA Rule 2090 (Know Your Customer) requires broker-dealer firms to use "reasonable diligence" with respect to the opening and maintenance of every account. This new "reasonable diligence" language replaced "due diligence" as the standard that was previously widely adopted from NYSE Rule 405(1). FINRA specifically states that it did not intend to change the standard, but only to change the language so that it is consistent with other FINRA publications.

The reference to both the "opening and maintenance" of every account is important to note. FINRA states in footnote 5 of the Notice that a broker-dealer must know its customers not only at account opening, but also throughout the life of its relationship with customers. There is no bright line test for how often a broker-dealer must update the information it has about a customer, but instead the broker-dealer must recognize that its relationship with its customers is "dynamic" and it must use its reasonable judgment at "intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances." There is reference to a related rule that requires updating information at least every 36 months; however our reading of that reference in no way suggests it as a bright line test.

The information that a broker-dealer must know, both at the opening of an account and at intervals thereafter, are the "essential facts" concerning that customer. These are determined to be "those [facts] required to (a) effectively service the customer's account, (b) act in accordance

with any 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."

Suitability – Reasonable Basis, Customer-Specific, and Quantitative Suitability

New FINRA Rule 2111 (Suitability) requires that a broker-dealer "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....." (emphasis added). The broker-dealer must take into consideration the customers age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and other information that the customer may disclose.

There are three separate suitability obligations:

Reasonable Basis Suitability requires that a broker-dealer have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. This is a look at the investment itself, and a determination that it is suitable for someone as an investment.

Customer-Specific Suitability requires that a broker-dealer have a reasonable basis to believe the recommendation is suitable for a particular customer based on that customer's investment profile. This is a look at the investment and the specific customer to determine if they are a match. Note: there is an exception to customer-specific suitability for institutional customers in certain circumstances.

Quantitative Suitability requires that a broker-dealer have a reasonable basis for believing that a particular investment, when taken together with that customer's other investments, are not excessive and unsuitable for the customer in light of the customer's investment profile. This is a look at the customer's entire portfolio.

Taken together, the broker-dealer must have a thorough understanding of both the investment, and the customer. Further, the broker-dealer cannot avoid its suitability obligations through the use of disclaimers.

Summary

The rules discussed above don't take effect until October 7, 2011. However, clients are advised to start implementing them now. Suitability questionnaires should be reviewed to ensure compliance with the reasonable diligence and essential facts standards set forth above, and internal policies for the periodic review and update of customer information should be developed.

For issuers who engage a broker-dealer to market their securities offering, there should be assurance that the broker-dealer is complying fully.

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