

Suitability and “Know Your Customer”

Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations

Comment Period Expires: June 29, 2009

Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on proposed consolidated FINRA rules governing suitability and know-your-customer (KYC) obligations.

The text of the proposed rules is set forth in Attachment A.

Questions regarding this *Notice* should be directed to James S. Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270.

Action Requested

FINRA encourages all interested parties to comment on the proposed rules. Comments must be received by June 29, 2009.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

May 2009

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Legal
- Compliance
- Senior Management

Key Topic(s)

- Suitability
- “Know Your Customer”

Referenced Rules & Notices

- FINRA Rule 2010
- NASD Rule 2310
- NASD IM-2310-3
- NASD Rule 3110
- NYSE Rule 405

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this Notice will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.²

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors and then must be approved by the SEC, following publication for public comment in the Federal Register.³

Discussion

NASD Rule 2310, addressing suitability obligations, and Incorporated NYSE Rule 405,⁴ addressing know-your-customer obligations, are critical to protecting investors. As a result, FINRA proposes to include modified forms of both rules in the Consolidated FINRA Rulebook. Each is discussed separately below.

Suitability

FINRA proposes to use the NASD suitability rule as the model for a modified suitability rule for the Consolidated FINRA Rulebook, proposed FINRA Rule 2111, and eliminate NASD Rule 2310.⁵ The modified rule would codify various interpretations regarding the scope of the suitability rule, clarify the information to be gathered and used as part of a suitability analysis and create a clear exemption for recommended transactions involving institutional customers, subject to specified conditions.

The Scope of the Proposed Suitability Rule

FINRA proposes to explicitly apply suitability obligations to a recommended transaction or investment strategy involving a security or securities. In this regard, the proposal would codify longstanding SEC and FINRA decisions and other interpretations stating that NASD Rule 2310 covers both recommended securities and strategies. For instance, NASD IM-2310-3 (the institutional customer interpretive material (IM), discussed below) explicitly states that firms' responsibilities under NASD Rule 2310 "include having a reasonable basis for recommending a particular security or strategy...." As with the current NASD rule, the proposed suitability rule would apply only if the firm or associated person makes a recommendation.

FINRA also proposes to codify in one place the discussions of the three main suitability obligations (reasonable basis, customer specific and quantitative),⁶ which are currently located in various IMs following NASD Rule 2310. The three obligations are discussed in a single section of the proposed suitability rule's supplementary material.

The proposed rule's supplementary material, moreover, includes a modified form of the current requirement in an IM that a firm refrain from "recommending purchases beyond a customer's capability." Additionally, the supplementary material maintains the discussion in two IMs regarding the suitability rule's significance in promoting fair dealing with customers and ethical sales practices.

In light of the more expansive application of some FINRA rules, such as those addressing just and equitable principles of trade and communications with the public, and given the seamless nature of a broker-dealer's business in providing financial services, FINRA also seeks comment on whether it should propose expanding suitability obligations to all recommendations of investment products, services and strategies made in connection with a firm's business, regardless of whether the recommendations involve securities.

Information Gathering Regarding the Proposed Suitability Rule

Proposed FINRA Rule 2111 contains a number of minor changes regarding the gathering and use of information as part of the suitability analysis. For instance, the information that must be analyzed in determining whether a recommendation is suitable would include not only information disclosed by the customer in response to the member firm's or associated person's reasonable efforts to obtain it, but also information about the customer that is "known by the member or associated person." The proposal also requires members or associated persons to make reasonable efforts to obtain more information than is explicitly required by NASD Rule 2310 (*e.g.*, age, investment experience, investment time horizon, liquidity needs and risk tolerance).

Clear Exemption for Institutional Customers

The proposed suitability rule includes in the rule text a clear exemption for transactions or investment strategies involving a security or securities recommended to institutional customers, subject to specified conditions. The suitability obligations applicable to institutional customers are currently located in NASD IM-2310-3 (the institutional customer IM). The proposed new provisions addressing institutional customers are significantly shorter and focus on three key factors:

- Whether the institutional customer affirmatively indicates that it is willing to forego the protection of the customer-specific obligation of the suitability rule;

- ▶ Whether the firm or associated person has a reasonable basis to believe that the institutional customer is capable of analyzing the risks of investments independently, both in general and with regard to particular transactions and investment strategies involving a security or securities; and
- ▶ Whether the firm or associated person has a reasonable basis to believe that the institutional customer is exercising independent judgment in evaluating the recommendations.

The proposal also clearly indicates that a firm fulfills its customer-specific suitability obligation to institutional customers if those factors are present.⁷ Finally, the proposal connects the definition of institutional customer to the definition of “institutional account” in NASD Rule 3110(c)(4). This change would eliminate the internal inconsistency that exists in the current NASD rule and would bring the definition of “institutional customer” up to date.⁸

Know Your Customer

FINRA proposes to transfer into the Consolidated FINRA Rulebook a modified version of NYSE Rule 405(1) requiring firms to use due diligence to know their customers and eliminate the NYSE version and its related supplementary material and rule interpretation. FINRA also proposes eliminating paragraphs (2) and (3) of NYSE Rule 405 and their related supplementary materials and rule interpretations as duplicative of NASD provisions that FINRA has proposed (or will be proposing) to be transferred into the Consolidated FINRA Rulebook. For instance, NYSE Rule 405(2) (Supervision of Accounts) is duplicative of NASD Rule 3010 (Supervision).⁹ Likewise, NYSE Rule 405(3) (Approval of Accounts) is duplicative of NASD Rules 3110(c)(1)(C) (Customer Account Information) and 3011 (Anti-Money Laundering Compliance Program) and, to a certain extent, the proposed modified version of NYSE Rule 405(1), discussed below.¹⁰

The proposed FINRA know-your-customer obligation, proposed FINRA Rule 2090, captures the main ethical standard of NYSE Rule 405(1). Firms would be required to use due diligence, in regard to the opening and maintenance of every account, to know the essential facts concerning every customer (including the customer’s financial profile and investment objectives or policy). This information may be used to aid the firm in all aspects of the customer/broker relationship, including, among other things, determining whether to approve the account, where to assign the account, whether to extend margin (and the extent thereof) and whether the customer has the financial ability to pay for transactions. The obligation arises at the beginning of the customer/broker relationship and does not depend on whether a recommendation has been made. FINRA *Notices* and other public pronouncements have stated that a similar know-your-customer obligation is embedded in the just and equitable principles of NASD Rule 2110 (now FINRA Rule 2010).¹¹

Endnotes

- 1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See SEA Section 19 and rules thereunder.
- 4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
- 5 NYSE Rule 405 has been interpreted as including implicit suitability obligations that are consonant with those imposed by NASD Rule 2310. The explicit provisions of NYSE Rule 405 are discussed in a separate section of this *Notice*.
- 6 There are three main suitability obligations: reasonable basis (firms must have a reasonable basis to believe, based on adequate due diligence, that a recommendation is suitable at least for *some* investors); customer specific (firms must have reasonable grounds to believe a recommendation is suitable for the specific investor); and quantitative (firms must have a reasonable basis to believe the number of recommended transactions within a certain period is not excessive.)
- 7 The current institutional customer IM is limited to customer-specific suitability. That remains true under the proposed rule.
- 8 NASD Rule 3110(c)(4) states that an “institutional account” includes an account of “(A) a bank, savings and loan association, insurance company, or registered investment company; (B) an investment adviser...; or (C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.” (FINRA is proposing to adopt NASD Rule 3110(c)(4) as FINRA Rule 4512(c). See *Regulatory Notice 08-25*.) NASD Rule 2310 currently refers to the definition of “institutional account” in NASD Rule 3110(c)(4), but the institutional customer IM uses a different definition for the term “institutional customer.” Most NASD rules that refer to institutional accounts/customers use the definition in NASD Rule 3110(c)(4), which has a different monetary threshold (\$50 million in assets) than does the institutional customer IM (\$10 million invested in securities and/or under management) and, unlike the institutional customer IM, NASD Rule 3110 allows a natural person to be viewed as an institutional account.

Endnotes

- 9 FINRA is proposing to adopt a modified version of NASD Rule 3010 as FINRA Rule 3110. *See Regulatory Notice 08-24* (May 2008).
- 10 FINRA also is proposing to eliminate NYSE Rule Interpretation 405/04 (Accounts in which Member Organizations have an Interest) because the same content is addressed by SEA Section 11(a), and the provision is specific to floor activities. FINRA, however, proposes to retain NYSE Rule 405(4) in the Transitional Rulebook and address its content at a later phase of the rulebook consolidation process.
- 11 *See* Exchange Act Release No. 44178 (April 12, 2001), 66 FR 20697, 20698 n.7 (April 24, 2001) (Notice of Filing and Immediate Effectiveness of NASD Proposed Rule Change Relating to Suitability Rule; SR-NASD-2001-20).

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined and proposed deletions are in brackets.

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Text of Proposed New FINRA Rules

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2000. DUTIES AND CONFLICTS

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2100. TRANSACTIONS WITH CUSTOMERS [GENERAL STANDARDS]

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2110. Recommendations

2111. Suitability

(a) A member or an associated person must 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 facts known by the member or associated person or disclosed by the customer in response to the member's or associated person's reasonable efforts to obtain information concerning 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 member or associated person considers to be reasonable in making recommendations.

(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in NASD Rule 3110(c)(4), if (1) the institutional customer affirmatively indicates that it is willing to forego the protection of the customer-specific obligation of the suitability rule and (2) the member or associated person has a reasonable basis to believe that the institutional customer is (A) capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (B) exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, these factors shall be applied to the agent.

••• Supplementary Material: — — — — —

.01 General Principles. Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore 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. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

.02 Components of Suitability Obligations. There are three main suitability obligations under Rule 2111: reasonable-basis suitability, customer-specific suitability and quantitative suitability. The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for at least some investors. In general, what constitutes adequate due diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. The customer-specific obligation requires that a member or associated person have reasonable grounds to believe that the recommendation is suitable for a particular customer based on that customer's profile, as delineated in Rule 2111(a). Quantitative suitability requires 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 in light of the customer's profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

.03 Customers' Financial Ability. Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities if such recommendation is inconsistent with the reasonable expectation that the customer has the financial ability to meet such a commitment.

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2090. Know Your Customer

Every member shall use due 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.

••• Supplementary Material: — — — — —

.01 Essential Facts. For purposes of this Rule, facts “essential” to “knowing the customer” include the customer’s financial profile and investment objectives or policy.

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