Doing Business Under FINRA's New Suitability and KYC Rules*

By Matthew C. Boba

The Financial Industry Regulatory Authority, Inc. ("FINRA") has delayed the implementation date of its new rules governing "know your customer" (FINRA Rule 2090) and suitability (FINRA Rule 2111) to July 9, 2012, to allow broker/dealers to better supervise and educate associated persons regarding the modified obligations. As it does not appear that any further reprieves will be forthcoming,[1] this article will outline the scope of both Rules and the practical effects of the Rules on registered representatives, supervisors and compliance professionals.

Know Your Customer Rule

The term "know your customer," for the purpose of broker/dealer regulation, describes the process by which a firm checks the identity, background, investment history and sources of investable funds of its customers. Generally, regulation requires firms to obtain evidence of identity of a customer at account opening and to keep a record of such evidence for as long as there is a relationship with a customer. In Regulatory Notice 09-25, FINRA provided that the information may be used to aid firms in all aspects of the customer relationship, including account approval, margin extension and in determining the customer's ability to pay for a transaction. Historically, best practices have required that a broker/dealer keep its knowledge of a customer up to date throughout the life of the relationship, so that changes in the customer's activity can be assessed as part of the supervision of the relationship. FINRA Rule 2090, described below, is an expansion and codification of the "know your customer" obligation of FINRA-member firms which is currently embedded in the "just and equitable principles" provision of FINRA Rule 2010.

The FINRA Rule 2090 "know your customer" obligation is modeled after NYSE Rule 405(1) and requires FINRA-member firms or its registered representatives to use "reasonable diligence" in regard to the opening and maintenance of every account and to know and retain the "essential facts" concerning every customer. Rule 2090 does not specifically address the requirements in current NYSE Rule

Matthew C. Boba is a partner with the law firm of Chapman and Cutler LLP whose practice includes corporate counseling, particularly broker/dealer compliance, and transactional representation of broker/dealers and other securities purchasers. Immediately prior to rejoining Chapman and Cutler in 2011, he served as executive vice president and general counsel of Howe Barnes Hoefer & Arnett, a Chicago-based, full service broker-dealer.

©2012, Matthew C. Boba

405(1) to learn the essential facts relative to "every order" which was originally intended by the NYSE to protect the broker/dealer by assuring that its customers can pay for their securities purchases through legitimate means. Historically, the theory for imposing liability on the broker/dealer for its customers' wrongful securities activities was derived from four theories: (1) the broker/dealer, as the "gateway" to the market, is in the most effective position to police its customers, (2) the broker/dealer is in a better financial position to absorb the losses caused by its customers, (3) broker/dealers are professionals who should abide by professional standards of responsibility in accepting their customers, and (4) the obligation is necessary to carry out the "fairness and honesty" and "investor protection" purposes of the Securities Exchange Act of 1934.[2]

Regardless of the theory and resulting case law, the current "know your customer" obligation as now codified, arises at the beginning of the customer relationship, is independent of whether a recommendation has been made, and relates to the broker/dealer's relationship with the customer, not just with respect to each securities transaction. Under the new regulatory framework, specific order handling rules such as FINRA Rule 5310, NASD Rule 2320, and NASD Rule 2400 govern the purchases and sales of securities. Similarly, Rule 2090 does not specifically address supervision or account opening as addressed by current NYSE Rule 405(2) and (3), as FINRA believes that these areas are explicitly covered by other rules. Then what does Rule 2090 do and what is its effect on a firm and its registered representatives?

Diligence

Following the initial Rule 2090 proposal in 2009,[3] FINRA has replaced the term "due diligence" with the term "reasonable diligence" for consistency with the suitability obligations under FINRA Rule 2111, but it is not intended for the new term to impair or adversely affect established case law or other interpretations under either obligation. Diligence, whether "due" or "reasonable," with respect to "know your customer" is the process by which a firm checks, among other things, the identity, investment history, investment objectives and the source of funds of potential and existing customers. This investigation provides two key benefits for a broker/dealer: (1) it provides comfort that the firm is not exposing itself to excessive risk of being used by criminals to launder funds (and is a key component to its AML program); and (2) knowledge of the customer allows the broker/dealer to recommend and sell financial products that are appropriate, or suitable, and that help the customer, the registered representative and the firm make money and, in some cases, avoid loss. The standard has not changed, but what is the established case law and what suffices as "due" or "reasonable diligence"?

Although much of the case law combines "know your customer" and suitability obligations, court decisions have established that the "know your customer" rule requires registered representative to have knowledge of a client's objectives, needs and circumstances or be prepared to say that the client has refused to identify those objectives.[4] Another court has ruled that a broker/dealer has a duty to make an affirmative inquiry as to the financial circumstances and position of a customer.[5] The starting point for this "know your customer" inquiry is the use of diligence as part of the new account application process.

For many independent broker/dealers, clearing firms can be of assistance in creating or updating new account applications that will capture most, if not all, of the essential facts about a customer to satisfy Rule 2090, such as personal information, employment information, bank references, income levels, net worth (both liquid and total), tax brackets, investment history, investment objectives, risk tolerance levels, interest and dividend payment instructions and financial institution affiliation. If your firm is on its own in the creation and updating of the new account application, the investment profile outlined in Rule 2111(a), discussed below, is a reasonable starting point for the types of information to be collected from each customer at account opening. As such, this information also becomes the starting point for a suitability analysis.

owever, "due" or "reasonable" diligence never becomes an issue when everything is right with a transaction, a customer or an account. Even with the best new account application form, a common issue arises when the form is returned with a few incomplete items. It may be that the customer doesn't want to disclose his or her income or net worth levels, failed to check the risk tolerance box, or wasn't sure of the difference between the objec-

tives of "growth" and "income." In most cases, the registered representative wants to add the customer and begin making trades immediately and, as the supervisor or compliance officer, your firm is faced with an incomplete application. How do you balance the representative's desires with your responsibilities?

Supplementary materials to Rule 2090 explain that "essential facts" are those 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. If something goes wrong with the account, the burden will be upon the broker/dealer to prove that permitting the account to be opened and activity to occur with incomplete information did not violate the reasonable diligence portion of the "know your customer" obligation. However, the analysis begs the question, if it wasn't important, why is it included as part of the firm's new account application? If you choose to proceed with the customer, the firm must make additional attempts to obtain the missing information from the customer and document the additional inquiries and the reason that the information was not provided. The supervisor will have to be alerted that the information is missing (assuming he or she did not previously approve the incomplete application). Then pay close attention to the account activity, especially early in the customer relationship, for indications that the omissions were not "essential facts." Like many of the issues facing compliance professionals, this becomes a judgment call based upon the representative's history, the quality of the information that was provided as part of the application and the risk tolerance of the firm's management.

Opening and Maintenance

Under Rule 2090, a broker/dealer's "know your customer" obligation exists both at the "opening and maintenance" of every customer account. FINRA states in footnote 5 of Regulatory Notice 11-02 that a broker/dealer "must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively *service and supervise* the customers' accounts." [Emphasis added.][6] However, FINRA provides no interval for how often a broker/dealer must update its customer records other than requiring that the broker/dealer must understand 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." That is not much help with creating your policies and procedures.

The FINRA Rule 2090 "know your customer" obligation … requires FINRA-member firms or its registered representatives to use "reasonable diligence" in regard to the opening and maintenance of every account and to know and retain the "essential facts" concerning every customer.

Rule 2090 contains a reference to amendments to SEC Rule 17a-3 which became effective in 2003 and required that a broker/dealer update client information at least every 36 months in making its suitability determinations. However, there is no assurance that 36 months is sufficient in addressing the maintenance requirement of Rule 2090. In fact, in the commentary regarding the adoption of its rule, the SEC specifically states:

> Although paragraph (a)(17)(i) of Rule 17a-3 requires broker-dealers to periodically update customer records, the rule does not affect a broker-dealer's obligations under any SRO "know your customer" rules. It may be appropriate in certain circumstances for broker-dealers to obtain updated information from customers more often than once every 36 months.[7]

Again, how does a broker/dealer protect itself when something goes wrong in an account in which the prospects of loss multiply due to a change in circumstances following the acceptance of a new customer and the opening of an account? In these situations, hindsight, whether from the regulators or opposing attorneys in an arbitration, is always

20/20. The firm "should have known" the customer (a) became unemployed six months after opening the account, (b) lost significant sums of money in other investments and no longer had the same level of net worth or risk tolerance, (c) began paying for his or her children's college educations and needed additional cash flow and liquidity, or (d) was in the process of a divorce which affected most everything on the application, etc. Sending firm-wide account updates more frequently than every 36 months gets expensive and may not suffice as "reasonable diligence" based upon frequent changes in the current economy or a firm's historic return rates from customers of the 36-month account update forms.

Fulfilling the know-your-customer obligation starts with the registered representative and extends from the most active accounts to the "buy and hold" customers (which are discussed below under new obligations under Rule 2111). It is imperative that the representative make contact with all of his or her customers on a regular basis. Sending confirmations, monthly statements (which may or may not have the current investment objective on the first page) and the annual birthday greeting will not suffice under the Rule 2090, which governs the "dynamic" customer relationship. This will not be news to talented, customer-oriented representatives. In any service-based profession, regular customer contact is essential to maintaining and growing your business. A broker/dealer's best employees, whether in sales, investment banking or trading, are disciplined in making their regular calls and have developed a trusting relationship with their customers. For others, supervision will require that a broker/dealer institutes a program that requires that customer calls are made, call records are kept and any essential facts concerning a customer are noted and the customer's profile is updated. Remember, FINRA states that "know your customer" applies to both the servicing and the supervision of customer accounts.

The tough part is that almost every representative will make regular customer contact when market conditions are favorable, his or her recent recommendations are proven correct and the account has increased in value. The trick is conducting reasonable diligence when the firm's best recommendations have decreased in price and the portfolio has lost 20 percent of its value since account opening. What representative wants to make a call in these circumstances? Though very few would be eager to make such a call, as stated above, a broker/dealer's diligence, as well as its policies and procedures, is primarily tested when things are going badly. This is when the firm principals have to supervise and the compliance officers have to monitor the supervision and enforce its policies and procedures. To imagine an even worse situation, how about an account losing value when a customer (a) has not had a regular source of income for six months, (b) has had his or her net worth decrease by 40 percent over the past year, (c) needs to write a large tuition check for the second semester, and/or (d) needs income and principal maintenance to meet financial obligations during a marital separation or following a divorce? Rule 2090 gives the regulators and customer's attorneys something tangible on which to base their allegations if a broker/dealer isn't diligent in fulfilling the obligation to know the essential facts in its maintenance of every account.

Without going too far down the litigation path, compliance professionals need to ensure that records are maintained and accessible. Treat these customer calls and any updates of "essential facts" as you would an "activity" call made or letter sent to a customer by one of the firm's supervisors to demonstrate that you are aware of your obligations under Rule 2090 and have policies and procedures in place to demonstrate compliance with the Rule. Although there is case law to support the notion that there is no private right of action under the "know your customer" rule absent fraud as misrepresentations,[8] claims often appear as part of the overall customer arbitration case. A terrific defense to a "know your customer" and resulting "lack of supervision" claim are frequent phone records, emails, file memos and blotters that indicate that the firm was fully aware of the customer, the account and the activity.

Understanding the Authority

The FINRA guidance includes an item regarding "know your customer" regarding the obligation to understand the authority of each person acting on behalf of a customer. FINRA clarified that the obligation generally requires that a firm not only know the name of authorized persons but also know any limits on the authority of those persons that the customer establishes and communicates to the broker/dealer. FINRA noted, however, that it is within the purview of any broker/dealer to ac-

cept only customers that do not limit the scope of authority of authorized persons.

Whenever dealing with potential customers that are entities, whether corporations, partnerships, trusts or other organizational forms, broker/dealers must be aware that the authority of the individual is established by the entity and that, without written evidence of authorization, no account should be opened nor should transactions be executed. Initial applications should be reviewed in conjunction with the authorization documents and quick Internet searches should be conducted on the entity and the individual officers in addition to following firm AML procedures.

Once an account is opened, unlike individual accounts, authorization can be lost or reduced in the normal course of business. As part of the codified "know your customer" maintenance requirements, best practices dictate that broker/dealers, as part of their reasonable diligence, obtain and retain new corporate authorizations on a regular basis (no less than annually) in addition to making periodic customer calls as outlined above.

An interesting situation arises in the case of joint accounts where an intervening event, such as separation or divorce, raises questions as to the authority of each account owner. Many account agreements will contain language to the effect that:

> Each owner has the authority to act on behalf of all owners to: order any transaction; receive any property in the account, including cash withdrawals; receive any communications concerning the account; and make any changes in the account, including closing the account. The firm is not required to verify with other account owners the authority for any instructions received from one of the owners and the firm does not need to give notice of any transaction to any owner who did not order the transaction.

Typically, at some point in the divorce process, a broker/dealer will receive a legal document from one party or the court which will alert it to the event, but under the dynamic "know your customer" standard, it is unknown if the language of the account agreement will be nullified if there has been no recent inquiry or contact by the firm and one spouse liquidates a joint account without the other's knowledge. Had the authority of each person changed without the firm's knowledge or recent inquiry? Did the firm truly understand the authority of each person with respect to the account if the registered representative had not spoken to either spouse in over a year? Again, regular contact with the customer should alert the representative of changes to the customer's essential facts.

Suitability Rule

The new FINRA Rule 2111 "suitability" obligation is modeled on former NASD Rule 2310. The new obligation requires a FINRA-member firm or its registered representative to 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. Rule 2111 was released with, and becomes effective with, Rule 2090 because many of the same principals apply. How can a firm make a suitability determination without knowing the customer?

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 a recommended transaction or investment strategy. Each of these items initially should be obtained by the broker/dealer as part of the new account application process and updated periodically as discussed above. A firm may not require every piece of the investment profile (and may call them different things), but FINRA has stated that a broker/dealer "must obtain and analyze *enough* customer information to have a reasonable basis to believe the recommendation is suitable." [Emphasis added.][9]

Keep in mind that FINRA explicitly stated in the notices that (1) a broker/dealer or its registered representative cannot disclaim any responsibilities under the suitability rule and (2) a broker/dealer does not have to update all customer-account documentation under Rule 2111, but it must "seek and obtain" the information. "Obtain" does not require documentation, but good luck proving during a

regulatory inquiry that you obtained the information but did not jot it down anywhere in your books and records! As stated later in the supplemental information issued in Regulatory Notice 11-25 (A.2.), "to the degree that the basis for suitability is not evident from the recommendation itself, FINRA examination *and enforcement* concerns will rise with the lack of documentary evidence for the recommendation." [Emphasis added.] When responding to an enforcement inquiry, you will be best served to include your documents. Without a document, you will be providing paragraphs of written text explaining all your suitability analysis. A picture, or in this case, a copy of your notes, is worth 1,000 words.

The new FINRA Rule 2111 "suitability" obligation … requires a FINRA-member firm or its registered representative to 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 investment profile should be developed at the beginning of the customer relationship as part of the new account application, updated throughout the relationship, complete, and able to be reproduced and used in the supervisory activities of the broker/dealer and as part of any regulatory inquiry. A firm should determine if its computer systems or those of its clearing firm allow for the reproduction and use of the customer data in fulfilling the suitability obligations.

Recommended Transaction

In its Rule proposals, FINRA noted that the determination of the existence of a "recommendation" is based on the facts and circumstance of a particular case. FINRA provided several guiding principles that are relevant to determining whether a particular customer communication could be viewed as a recommendation under the suitability rule.

First, FINRA views a communication's content, context and presentation as important aspects of an inquiry and the determination of whether a "recommendation" has been made is an objective rather than subjective inquiry. FINRA has repeatedly explained that a broker/dealer cannot avoid suitability obligations through a disclaimer where, given its content, context and presentation, the particular communication reasonably would be viewed as a recommendation. A factor in this regard is whether a particular communication to a customer reasonably would be viewed as a suggestion that the customer take action, or refrain from taking action, regarding a security or investment strategy given the communication's content, context and manner of presentation. Supervisors should be aware of this factor in conducting their periodic review of customer communications.

Second, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed by FINRA as a recommendation. Again, if a firm principal is unsure of the purpose of the communication, he or she should discuss the materials with the registered representative prior to granting approval.

Finally, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. FINRA has also stated that there is no difference whether a communication was initiated by a person or through a computer software program. These guiding principles, together with litigated decisions and the facts and circumstances of any particular case, form the determination of whether the communication is a recommendation for purposes of Rule 2111.

Investment Strategy

Rule 2111 also introduces the "investment strategy" concept to the suitability rule so that the obligation explicitly covers a recommended "investment strategy" in addition to a recommended

purchase, sale or exchange transaction. The term "investment strategy involving a security or securities" will be interpreted broadly by FINRA and is triggered when a broker/dealer or its registered representative recommends a security or strategy regardless of whether the recommendation results in a transaction. Again, it is not required that a transaction occurs in determining whether a broker/dealer has a suitability obligation with respect to the recommendation.

Among other things, the term "strategy" would capture a registered representative's explicit recommendation to *hold* a security or securities (where no transaction occurs), trade on margin or, in FINRA's language, "liquefied home equity." Rule 2111 recognizes that a customer may rely on a broker/dealer's and its registered representative's expertise and knowledge, and it is thus appropriate, according to FINRA, to hold firms responsible for the recommendations made to their customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation. This may require that a firm generates a new set of supervisory or compliance reports. Does a firm need to review "non-active accounts" to ensure that the suitability obligations of a "hold" strategy are being met or that regular contact has been made in order to update the customer's profile?

In Regulatory Notice 11-25 (A.8.), FINRA has stated that, absent special circumstances, "a hold recommendation would not create an ongoing duty to monitor" (and would be consistent with case law on the rights of "holders" to sue under Rule 10b-5). FINRA made clear that although the inclusion of "strategy" recommendations within the suitability rule captures an *explicit* recommendation to hold a security, it would not capture an *implicit* recommendation to hold a security (such as where a representative remains silent regarding a security in an account or refrains from recommending a sale). [Emphasis added.] In addition, FINRA clarified that absent an agreement, course of conduct or unusual situation that would change the normal broker/dealer relationship with a customer, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations. But what is an unusual situation? How does a "hold" work in connection with a customer's current investment profile and investment strategy? Can an "explicit" hold recommendation change to an "implicit" hold recommendation over time? How does the attempted clarification apply when combined with the new monitoring and disclosure obligations with respect to customers who hold municipal bonds? These questions only can be answered over time as FINRA, the SEC, arbitration panels and the courts interpret and enforce this expanded obligation.

Additionally, broker/dealers should examine their margin disclosure forms to determine if the disclosures, and the margin agreements themselves, need to be enhanced to take into account the ongoing suitability analysis and obligations with respect to continued maintenance of any customer's margin accounts in light of shifts in strategy or changes in the investor profile. Does the margin agreement place an affirmative obligation on the customer to update his or her personal information? Margin accounts, as well as penny stocks, options and illiquid securities, which increase a customer's risk profile in varying degrees, may require additional supervisory attention to customers using these strategies.

When combined with the continuing obligations under Rule 2090, a broker/dealer must keep in mind that its recommended strategies at account opening, even a conservative, long term "buy and hold" strategy or creating an income-producing, investment grade bond portfolio, have the potential of no longer being suitable for a customer due to change of circumstances. Simply recommending transactions from time to time may constitute the overall account strategy and need to be documented for the account. FINRA has not mandated a fiduciary duty to customers, but, when added to the continuing responsibilities to customers who hold bonds in their brokerage accounts, we're getting close to that standard. FINRA has noted that "the application of a suitability standard is not inconsistent with a fiduciary duty standard."[10] See a brief discussion of Dodd-Frank below.

FINRA did exempt certain categories of educational material from Rule 2111's coverage as long as such material does not include (alone or in combination with other communications) a recommendation of a particular security or securities. The following communications are excluded from coverage as long as they do not

include a recommendation of a particular security or securities:

- General financial and investment information, including (a) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax-deferred investment, (b) historic differences in the return of asset classes (*e.g.,* equities, bonds, or cash) based on standard market indices, (c) effects of inflation, (d) estimating future retirement income needs, and (e) 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 (a) based on generally accepted investment theory, (b) 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 (c) 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 exceptions seem appropriate but compliance professionals should be alert to the conclusion sections of any presumed excluded communication because a recommendation of a transaction or investment strategy may be lurking in any "call to action" or "next steps" portion of the communication. Educate your registered representatives as to what constitutes a recommendation to customers and provide guidelines in your policies and procedures.

Three Main Suitability Obligations

The supplementary materials to Rule 2111 also codify interpretations of the three historic suitability obligations:

- ***Reasonable Basis Obligation*** – a FINRA-member or its registered representative must 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 its registered representative's familiarity with the security or investment strategy.
- ***Customer-Specific Obligation*** – a FINRA-member or its registered representative must have reasonable grounds to believe that the recommendation to a customer is suitable for that particular customer based on that customer's investment profile.
- ***Quantitative Suitability*** – a FINRA member or its registered representative who has actual or de facto control over a customer account must have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. 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.

For those compliance professionals who have had experience with customer arbitrations, these obligations are not new and analysis of these individual concepts is a main component of the firm's defense (it was a good security, it was appropriate for the customer and the firm did not churn the account or overweight the portfolio in similar securities). Again, the regulatory suitability focus is no longer on each individual securities transaction. FINRA has codified, broadened and specified the suitability obligation. Its use of standards such as "adequate due diligence," "reasonable grounds" and "reasonable basis" above should tell you that a firm must be able to prove through documentation (whether paper or electronic storage) that it has satisfied its obligations both to the customer and to the regulators.

Rule 2111 also provides an exemption to customer-specific suitability for recommendations to institutional customers under certain circumstances. The new exemption focuses on whether there is a reasonable basis to believe that the customer is capable of evaluating risks independently and is exercising independent judgment in evaluating recommendations. In addition, the exception requires

institutional customers to indicate affirmatively that they are exercising independent judgment. The rule is intended to harmonize the definition of institutional customer in the suitability rule with the more common definition of "institutional account" in NASD Rule 3110(c)(4). Specifically, the new rule provides the customer-specific suitability obligation for an institutional account if a (1) the FINRA member or registered representative has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities, and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the FINRA member's or registered representative's recommendations. Where an institutional customer has delegated decision making authority to an agent, such as an investment adviser or a bank trust department, these factors would be required to be applied to the agent.

Elimination of Interpretive Materials

Rule 2111 eliminates or modifies a number of FINRA interpretive materials because they either are no longer necessary or are redundant. Certain interpretive materials have been incorporated in some form into the new rule or its supplementary materials. For example, the exemption in IM-2310-3 dealing with institutional customers is modified and moved into the text of the new rule and the three main suitability obligations, currently located in IM-2310-2 and IM-2310-3, are consolidated into a single discussion in the supplementary materials. Similarly, the supplementary materials include a modified form of the requirement in IM-2310-2 that a member refrain from recommending purchases beyond a customer's capability. The supplementary materials also retain the discussion in IM-2310-2 and IM-2310-3 regarding the suitability rule's significance in promoting fair dealing with customers and ethical sales practices.

The only type of misconduct identified in existing interpretive materials that is neither explicitly covered by other rules nor incorporated in some form into the new suitability rule is unauthorized trading, which is discussed in existing IM-2310-2. However, in the view of FINRA, it is well settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010 (previously NASD Rule 2110).

The FINRA guidance also includes ten items on specific aspects of Rule 2111. Of interest is that FINRA has noted that due diligence review and approval of a product by a broker/dealer's "product committee" does not necessarily mean that its registered representatives have complied with the "reasonable basis" obligation. As a result, a registered representative's lack of understanding of a product or strategy could result in a violation of Rule 2111 even if the firm's product committee has reviewed and approved the product or strategy. From a compliance standpoint, firms have additional reasons to ensure that its registered representatives are educated and knowledgeable about their recommendations. The questions are not only "which is it?" and "what does it do?" but now include "why that customer?"

Relationship with a Potential Broker/Dealer Fiduciary Duty Permitted by the Recent Financial Reform Legislation?

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") amends existing securities laws to expressly permit the SEC to adopt rules that provide a standard of conduct for broker/dealers when they provide personalized investment advice to customers. Dodd-Frank thus permits the SEC to adopt a standard of conduct beyond the "know your customer" and suitability obligations of FINRA Rules 2090 and 2111. In the proposal to the new Rules, the SEC and FINRA noted that the obligations set forth therein would not be inconsistent with the addition of a fiduciary duty obligation at some future date. Indeed, the SEC and FINRA both appear to believe that the suitability obligation is a material part of a fiduciary standard in the context of investment advice and recommendations. As a result, the SEC and FINRA evidently did not feel a need to postpone the new Rules until a broker/dealer fiduciary standard is fully considered under the Dodd-Frank Act amendments. If the SEC adopts any broker/dealer fiduciary duty rule in the future, FINRA-member firms would presumably need to address customer care standards separately as rules are adopted.

Because Dodd-Frank permits, but does not require, the SEC to adopt rules setting a standard of care applicable to broker/dealers, there is no

assurance that a broker/dealer standard of care beyond the suitability obligation will be adopted. However, SEC Commissioners on several occasions have stated their support for such a standard. Accordingly, broker/dealers also should consider the implications of any future fiduciary duty obligation proposal by the SEC in considering their Rule 2090 and Rule 2111 obligations.

Conclusion

The pending effectiveness of the FINRA Rules 2090 and 2111 on "know your customer" and suitability expands the historical practices in addressing these obligations. This expansion will require additional policies and procedures for broker/dealers in addressing incomplete account applications, updating the essential information about a customer, reviewing recommendations by its representatives as well as, the context of any recommendations, and all three explicit suitability obligations, reasonable basis, customer-specific and quantitative. As the industry inches closer to an overall fiduciary duty, it should be noted that FINRA is confident that a representative's recommendations must be consistent with his customer's best interests.

ENDNOTES

[*] This article has been prepared by a Chapman and Cutler LLP attorney for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this article, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

[1] In January 2012's Regulatory Notice 12-03, as part of the discussion of heightened supervision for complex products, FINRA again makes clear that FINRA Rule 2111 will take effect on July 9, 2012 and cites the supplementary materials contained in Rule 2111.05(a), not current NASD Rule 2310 as authority for the discussion.

[2] See Note, "The 'Know Your Customer' Rule of the NYSE Liability of Broker-Dealer under the UCC & Federal Securities Laws," 1973 Duke L.J. 489.

[3] See FINRA Regulatory Notice 09-25.

[4] See *Lichtenstein v. Kidder, Peabody & Co., Inc.*, 840 F. Supp. 374 (W.D. Pa. 1993).

[5] *Erdos v. SEC,* 842 F.2d 507 (9th Cir. 1984)

[6] See FINRA Regulatory Notice 11-02.

[7] See SEC Release No. 34-44992; File No. S7-26-98.

[8] For detailed discussion, see Jerry W. Markham & Thomas Lee Hazen, "Broker-Dealer Operations and Regulation under Securities and Commodities Laws," Volume 23A, Section 10:10.

[9] See FINRA Regulatory Notice 11-25, Answer 3 (A.3.).

[10] See FINRA Form 19b-4 (S.R. 2010-039); p.17 of 776 filed with the SEC on July 30, 2010.

This article is reprinted with permission from *Practical Compliance and Risk Management for the Securities Industry,* a professional journal published by Wolters Kluwer Financial Services, Inc. This article may not be further re-published without permission from Wolters Kluwer Financial Services, Inc. For more information on this journal or to order a subscription to *Practical Compliance and Risk Management for the Securities Industry,* go to **onlinestore.cch.com** and search keywords "practical compliance"