

Client Alert

Current Issues Relevant to Our Clients

October 2, 2013

Broker-Dealer Suitability—FINRA Summarizes Exam Approach and Highlights Effective Practices

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued Regulatory Notice 13-31 summarizing the typical approach of FINRA examinations on suitability compliance and highlighting effective practices used by member firms to meet suitability obligations under FINRA Rule 2111. The FINRA notice provides a useful resource for broker-dealers in assessing their compliance policies and procedures under the FINRA suitability rule. The notice also summarizes other resources that FINRA has introduced since the effectiveness of the new FINRA suitability rule in July 2012. The FINRA notice is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p351220.pdf>.

For additional information on the FINRA Rule 2111 suitability requirements, please refer to our previous publications:

- FINRA Issues Additional Guidance on Suitability Rule (December 17, 2012), available at http://www.chapman.com/media/publication/137_1223links.pdf
- FINRA Issues Additional Guidance on New Suitability Rule (June 6, 2012), available at http://www.chapman.com/media/publication/138_1177links.pdf
- Doing Business Under FINRA’s New Suitability and KYC Rules (April 10, 2012), available at http://www.chapman.com/media/publication/76_media.1172.pdf

The Municipal Securities Rulemaking Board is also in the process of updating its suitability rule applicable to municipal securities transactions. For our most recent discussion of this and related MSRB rule changes, please see our September 30, 2013 Client Alert available at http://www.chapman.com/media/publication/230_IMAlert.pdf.

The Examination Process

To assist broker-dealers in compliance with their suitability obligations under FINRA Rule 2111, FINRA outlined its typical process when examining firms for compliance. FINRA notes that exams typically begin with an analysis of a firm’s controls. This analysis generally focuses on interviews with principals responsible for preparing suitability-related compliance policies and assessing the firm’s readiness to control suitability-related risks based on the types of products sold by the firm and the types of customers of the firm. The depth and breadth of any exam ultimately depends on a firm’s supervisory systems and controls, the products and strategies the firm recommends, the firm’s business activities, the firm’s customer base, and other relevant information considered by FINRA staff during the examination planning and execution process. The FINRA notice linked above also includes specific examples of questions asked by examiners and typical information and document requests

of examiners in typical suitability examinations. These requests generally focus on suitability training, existing policies, procedures and resources, and supervision of suitability compliance. Firms should consider the questions and requests outlined in the FINRA notice in preparation for future exams.

Following receipt of requested information, examiners generally review internal firm controls to determine whether firm procedures are being followed. FINRA notes that examiners generally review transactions and related suitability documentation that raise red flags, such as:

- those that appear to deviate from the firm’s internal suitability guidelines for a particular security;
- a long-term investment for an investor with a short-term horizon;

- a speculative investment or strategy held in the account of an investor with a conservative investment objective; and
- the same security held in the account or strategy implemented for multiple investors of a particular representative despite customer profiles that differ.

FINRA notes that, although examiners review firm documents used to supervise suitability decisions and rule requirements, the suitability rule generally does not impose explicit documentation requirements. FINRA has stated that firms may take a risk-based approach to document compliance with the suitability rule and the complexity and risks associated with a particular security or investment strategy will impact the level of documented analysis.

Since the new suitability rule has only been in effect since July 2012, many firms have not been through a normal FINRA cycle examination since the rule has been effective. However, FINRA has found that most firms examined since this time have updated policies, procedures and systems, trained staff and obtained additional customer investment profile information. The most common exam deficiency cited by FINRA was inadequate procedures for hold recommendations (a new facet introduced in FINRA Rule 2111 compared to the old rule). Most firms with examination deficiencies were issued a Cautionary Action for inadequate supervisory procedures (i.e., no formal disciplinary action), while a few were referred to FINRA's Enforcement Department for violations under the previous suitability rule.

Effective Practices

The FINRA notice outlines a variety of effective compliance practices observed by FINRA in recent examinations. While compliance with the listed practices will not ensure suitability rule compliance, FINRA believes that the practices summarized in the notice can bolster a firm's supervisory and compliance procedures. FINRA notes that there is no "one-size-fits-all" approach to effective compliance, firms are not bound by the listed practices and firms may employ other methods to achieve compliance with the suitability rule.

Reasonable-Basis Suitability—Reasonable-basis suitability requires that a firm perform reasonable diligence to determine whether a security recommendation is suitable for at least some investors. Many firms have instituted new product review processes that assist in satisfying this obligation. Large firms often have extensive frameworks but FINRA has found that even smaller firms generally have investment committees to review complex or risky products for reasonable-basis suitability purposes and to determine potentially suitable customer profiles.

FINRA notes that new product reviews do not alone fulfill the need for associated persons to understand recommended investment products and strategies. Accordingly, some firms post due diligence information on products (and accompanying documents) to an internal website that associated persons can access when recommending a product. This information might include audited financial statements, notes of interviews with key individuals of the product sponsor or issuer, and other information relevant to understanding the product and its features. Furthermore, some firms train associated persons about new products and certain training programs go a step further by requiring testing prior to selling new products.

Customer-Specific Suitability—One of the differences in FINRA Rule 2111 from the prior suitability rule is that the new rule requires a firm to seek to obtain and analyze additional customer information compared to the old rule, such as customer age, investment experience and risk tolerance, and other factors. FINRA examiners found that many firms began collecting this additional information prior to adoption of the new rule through updated account forms and implementing technological systems, such as electronic customer relationship management systems. FINRA found that some firms have reexamined their entire client base through various methods. Some firms have also implemented systems that flag recommended transactions for customers who do not have complete profiles, while others refuse to execute recommended transactions for clients who have not completed or updated their account information (i.e., they are restricted to non-recommended transactions until they update or complete information). Some firms have also made greater use of specific suitability requirements or customer profiles to assess whether particular securities or investment strategies may be appropriate for customers or customer profiles.

Quantitative Suitability—Due to the similarity of the new and old rules regarding quantitative suitability, FINRA has found that most firms examined already monitored accounts for churning and excessive trading prior to effectiveness of the new rule. Nonetheless, some firms have modified their surveillance systems to integrate new data analysis that accounts for quantitative suitability obligations. FINRA also noted that it believes that firms could also analyze whether their compensation arrangements could incentivize representatives to recommend unsuitable excessive trading.

Institutional Customer Exemption—The new suitability rule provides an exemption from the customer-specific suitability branch of the rule for certain institutional customers. Among other requirements, the exemption requires that a firm obtain affirmative (but not necessarily written) acknowledgement that the customer is exercising independent judgment in evaluating recommendations. FINRA found that some firms have implemented specific

account opening forms for institutional customers, which require the institutional customers to acknowledge in writing that they will exercise independent judgment in evaluating recommendations. Other firms discuss recommendations with institutional customers in order to elicit affirmative oral acknowledgments while documenting the conversation. In addition, some firms employ third parties to verify institutional status and sophistication of customers. Where institutional customers do not exercise independent judgment, certain firms document the circumstances under which independent judgment is exercised and flag recommendations that are not covered. Other firms simply service only those institutional customers that will agree to exercise independent judgment or designate accounts as restricted to non-recommended transactions.

Hold and Other Investment Strategy

Recommendations—One of the most significant changes in the new suitability rule is the explicit application to “hold” recommendations and recommendations of investment “strategies”. As might be expected, FINRA examiners found hold recommendation practices to be the most frequent deficiency area in recent exams. However, FINRA notes that some firms instituted systems to achieve compliance with the new hold/investment strategy aspects of the rule. Some examples of these systems include:

- a “hold ticket” or a “hold blotter” that captures hold and or other strategy recommendations;
- notes of discussions with clients regarding explicit hold or other strategy recommendations maintained in customer files;
- branch office inspections focused on documentation of hold and other strategy conversations with clients;
- modified new account forms to include specific investment strategies that could be identified if an associated person recommends them at the time of account opening;
- new or amended account opening forms that must be signed by the customer when associated persons recommend changes to a previously recommended account investment strategy;
- a prohibition on associated persons engaging firm clients in the associated persons’ outside business activities; and
- employing clearing platforms with “note capabilities” that provide representatives the ability to document client conversations on hold and other strategy recommendations.

This aspect of FINRA Rule 2111 has clearly been received by member firms as a material change from the old rule.

As a result, FINRA has received feedback that these new obligations present behavioral and cultural challenges from past practices. To address this issue, many firms have implemented training programs on these issues that include periodic sales meetings, continuing education, annual compliance meetings, onsite inspections and compliance alerts.

Supervision—Among the supervisory systems used by firms, FINRA noted that effective supervisory procedures delineate who is responsible for conducting a specific review, what will be reviewed, the frequency of reviews and required documentation to evidence the review. FINRA also emphasized the importance of using a standardized approach to monitoring and updating policies and procedures as functions, personnel and systems change within a firm. The FINRA notice describes certain other aspects of supervisory systems but it appears that recent examinations generally did not find significant deficiencies regarding suitability supervision.

What Should I Do Now?

FINRA encourages firms to carefully consider the effective practices cited in the recent notice in the near term rather than wait for a regulatory examination. By doing this, FINRA believes that firms may be able to better assess whether additional efforts are appropriate to improve approaches to suitability determinations and the supervision of recommendations.

For More Information

To discuss any topic covered in this client alert, contact a member of the Investment Management Group or visit us online at Chapman.com.

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