Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS JANUARY 18, 2011

SEC Approves FINRA Know-Your-Customer and Suitability Rules

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued Regulatory Notice 11-02 to alert members that the Securities and Exchange Commission ("SEC") recently approved new rules governing know-your-customer and suitability obligations. New FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) are based in large part on NYSE Rule 405(1) (Diligence as to Accounts) and NASD Rule 2310 (Recommendations to Customers (Suitability)) and related interpretive materials. The rules changes delete NASD Rule 2310, IM-2310-1 (Possible Application of SEC Rules 15g-1 through 15g-9), IM-2310-2 (Fair Dealing with Customers), IM-2310-3 (Suitability Obligations to Institutional Customers), NYSE Rule 405(1) through (3) (including NYSE Supplementary Material 405.10 through .30), and NYSE Rule Interpretations 405/01 through /04. The core features of the obligations set forth in NYSE Rule 405(1) and NASD Rule 2310 remain intact but the modifications are intended to strengthen and clarify the rules. For additional information, please refer to our Client Alert dated August 30, 2010 entitled "SEC Requests Comments on FINRA Know Your Customer and Suitability Rule Proposals."

FINRA Regulatory Notice 11-02 is available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf. The text of the new rules is set forth therein. The rules take effect October 7, 2011.

Know Your Customer Rule

The new FINRA Rule 2090 "know your customer" obligation is modeled after former NYSE Rule 405(1) and requires FINRA member firms or associated persons to use "reasonable diligence"[1] in regard to the opening and maintenance of every account and to know and retain the "essential facts" concerning every customer. The obligation arises at the beginning of the customer/broker relationship, independent of whether the broker-dealer has made a recommendation. The supplementary material to the new rule explains 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.

FINRA Rule 2090 does not specifically address the requirements in current NYSE Rule 405(1) to learn the essential facts relative to "every order". Similarly, the new rule does not specifically address supervision or account opening as addressed by current NYSE Rule 405(2) and (3). FINRA believes that these areas are explicitly covered by other rules.

Suitability Rule

The new FINRA Rule 2111 "suitability" obligation is modeled on former NASD Rule 2310. The new rule requires a FINRA member firm or associated person to have a reasonable basis to believe that a recommended transaction or

1 FINRA notes that it replaced the term "due diligence" with the term "reasonable diligence" for consistency with new FINRA Rule 2111, but does not intend for the new term to impair or adversely affect established case law or other interpretations.

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. 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.

FINRA notes that although the determination of the existence of a "recommendation" is based on the facts and circumstances of a particular case, several guiding principles are relevant to determining whether a particular 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. The determination of whether a "recommendation" has been made is an objective rather than subjective inquiry. FINRA has repeatedly explained that a broker cannot avoid suitability obligations through a disclaimer where—given its content, context and presentation—the particular communication reasonably would be viewed as a recommendation. Moreover, the new rule's supplementary material explicitly states that a firm or associated person cannot disclaim any responsibilities under the suitability rule. 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. 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 as a recommendation. 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 a computer software program. These guiding principles, together with litigated decisions and the facts and circumstances of any particular case, inform the determination of whether the communication is a recommendation for purposes of FINRA's suitability rule.

The new suitability rule also introduces the "investment strategy" concept to the suitability rule so that the rule explicitly covers a recommended "investment strategy" in addition to a recommended "transaction". The rule emphasizes that the term "investment strategy involving a security or securities" is to be interpreted broadly. The rule is triggered when a firm or associated person recommends a security or strategy regardless of whether the recommendation results in a transaction. Among other things, the term "strategy" would capture a broker's explicit recommendation to hold a security or securities (i.e., where no transaction occurs). The rule recognizes that customers may rely on firms' and associated persons' investment expertise and knowledge, and it is thus appropriate to hold firms and associated persons responsible for the recommendations that they make to customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation. FINRA, however, exempted from the new rule's coverage certain categories of educational material as long as such material does not include (standing alone or in combination with other communications) a recommendation of a particular security or securities. The following communications are excluded from the coverage of Rule 2111 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 supplementary material of the new suitability rule also codifies interpretations of the three main suitability obligations:

- *Reasonable Basis Obligation*—a FINRA member or associated person 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 associated person's familiarity with the security or investment strategy.
- *Customer-Specific Obligation*—a FINRA member or associated person 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, as delineated in Rule 2111(a).
- *Quantitative Suitability Obligation*—a FINRA member or associated person 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, are not excessive and unsuitable for the customer when taken together in light of the customer's investment 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.

The new rule 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 rule requires institutional customers to affirmatively indicate that they are exercising independent judgment. The rule harmonizes 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 that a member or associated person fulfills the customer-specific suitability obligation for an institutional account if (1) the member or associated person 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 member's or associated person'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.

The new suitability rule eliminates or modifies a number of FINRA interpretive materials because they are either no longer necessary or are redundant. Certain interpretive materials have been incorporated in some form into the new rule or its supplementary material. 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 material. Similarly, the supplementary material includes a modified form of the requirement in IM-2310-2 that a member refrain from recommending purchases beyond a customer's capability. The supplementary material also retains 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, it is the view of FINRA that it is well-settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010 (previously NASD Rule 2110).

How Does This Proposal Relate to a Potential Broker-Dealer Fiduciary Duty Rule Permitted by the Recent Financial Reform Legislation?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") 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. For additional information, see our July 27, 2010 client alert, "Broker-Dealer and Investment Adviser Fiduciary Duties Under the Dodd-Frank Wall Street Reform and Consumer Protection Act; SEC Request for Comments". These Dodd-Frank Act amendments permit 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 FINRA rules, the SEC and FINRA noted that the obligations set forth 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 FINRA 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 they are adopted.

Because the Dodd-Frank Act permits, but does not require, the SEC to adopt rules setting forth a standard of care applicable to broker-dealers, there is no assurance that a broker-dealer standard of care will be adopted beyond the suitability obligation. However, SEC Chairman Mary Shapiro and certain other SEC Commissioners have stated their support for such a standard on several occasions. Accordingly, FINRA members should consider the implications of a future fiduciary duty obligation proposal by the SEC in considering the current FINRA Rule 2090 and Rule 2111 obligations. The SEC is scheduled to release its report to Congress regarding the study of the obligations of brokers-dealers and investment advisers in the next few days.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.