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THE SEC APPROVES NEW, EXPANDED RULES ON KNOW YOUR CUSTOMER AND SUITABILITY

On November 17, 2010, the Securities and Exchange Commission (SEC) approved two rules that had previously been proposed by FINRA: Rule 2090 (Know Your Customer) and Rule 2111 (Suitability).[1] When they take effect on October 7th of this year, the new Suitability and Know Your Customer Rules will replace NYSE Rule 405 and NASD Rule 2310.[2] As outlined in FINRA's Regulatory Notice 11-02,[3] the new rules contain several notable changes from the rules they will be replacing. Collectively, the new rules: (a) expand the scope of suitability requirements from solely buy and sell recommendations to now include "investment strategies;" (b) create a suitability obligation where a broker-dealer or an associated person makes a recommendation to hold an investment; and (c) identifies three distinct suitability obligations: (1) a reasonable-basis suitability, (2) customer-specific suitability and (3) quantitative suitability.[4]

FINRA Rule 2090: Know Your Customer

New FINRA Rule 2090 (commonly referred to as the "Know Your Customer Rule") is generally modeled after former NYSE Rule 405(1) and requires firms to use "reasonable diligence" in gathering client information from the outset of the broker-customer relationship. With regard to the opening and maintenance of customer accounts, Rule 2090 also requires knowledge of the essential facts concerning every customer. The 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."[5] Rule 2090, unlike suitability, is activated at the beginning of the broker-customer relationship and does not depend on whether a recommendation has been made.

FINRA Rule 2111: Suitability

New FINRA Rule 2111 generally is patterned after the rule it replaces, and requires that a broker-dealer or an associated person "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."[6] The rule further explains that a "customer's investment profile" generally includes information relating to the customer's age, other investments, financial situation, income needs, tax status, investment objectives, investment

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[1] *See* Securities Exchange Act Release No. 63325 (November 17, 2010), 75 FR 71479 (November 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039).
[2] Complete copies of the new rules are available at:
http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9858 and
http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9859.
[3] *See* FINRA Notice 11-02 (January 2011), *available at*
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.
[4] *See id.*
[5] FINRA Rule 2090.01.
[6] FINRA Rule 2111(a).

experience, investment time horizon, liquidity needs, risk tolerance, and other information disclosed by the customer pertaining to a recommendation. Much like the rule it replaces, Rule 2111 uses a recommendation as the triggering event for the activation of suitability obligations, regardless of whether a purchase or sale is eventually made.

Suitability: Recommendations

The existence of a recommendation traditionally has been based on the surrounding facts and circumstances of a particular case.[7] In determining whether an activity rises to the level of becoming a "recommendation," a communication's content, context and presentation are important aspects of the inquiry. For example, it is important to consider whether a particular communication from a broker to a customer reasonably would be interpreted as a suggestion for the customer to take action (or inaction) regarding a security or investment strategy. Furthermore, the more custom tailored a communication is to a customer about a specific security or investment strategy, the more likely the communication will be deemed to be a recommendation.

Suitability: Investment Strategies

Rule 2111 explicitly applies to recommended *investment strategies* involving a security or securities.[8] The rule itself urges that the term "strategy" be interpreted broadly.[9] Accordingly, the term "strategy" would capture a broker's explicit recommendation to hold a security.[10] The rule assumes that customers rely on financial professionals' expertise and knowledge, and consequently, FINRA deems it appropriate to hold broker-dealers and their associated persons responsible for the recommendations that they make to customers.

Suitability: Customer's Investment Profile

The new Suitability Rule includes an expanded list of explicit types of information that broker-dealers must attempt to gather and analyze as part of a suitability analysis. The rule now explicitly requires broker-dealers to collect information regarding a customer's age, investment experience, time horizon, liquidity needs and risk tolerance in addition to the existing list (other holdings, financial situation and needs, tax status and investment objectives).[11] Recognizing that not every factor regarding a customer's investment profile will be relevant to every recommendation, the rule provides flexibility concerning the type of information that firms must seek to obtain and analyze.[12] However, because the listed factors generally are relevant to a suitability analysis, the rule requires firms and associated persons to document with specificity their reasonable basis for believing that a factor is not relevant in order to be relieved of the obligation to seek to obtain information.[13]

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[7] FINRA has stated that "defining the term 'recommendation' is unnecessary and would raise many complex issues in the absence of specific facts of a particular case." Securities Exchange Act Release No. 37588, 1996 SEC LEXI2285, at 29 (August 20, 1996).
[8] *See* FINRA Rules 2111(a) and 2111.03 (emphasis added).
[9] *Id.*
[10] *Id.*
[11] *See* FINRA Rule 2111(a).
[12] *See* FINRA Rule 2111.04.
[13] *Id.*

Suitability: Three Main Obligations

As noted above, the new suitability rule lists the three main types of suitability obligations: reasonable-basis, customer-specific and quantitative suitability.[14]

- Reasonable-basis suitability requires a broker to have a reasonable basis to believe, based on "reasonable diligence" that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or strategy and the firm's or associated person's familiarity with the security or strategy.
- Customer-specific suitability requires that a broker have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. As noted above, the new rule requires a broker to attempt to obtain and analyze a newly broadened array of customer-specific factors.
- Quantitative suitability requires a broker 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. Factors such as turnover rate, cost-equity ratio and use of in-and-out trading may provide a basis for finding that the activity at issue was excessive.

The new rule makes clear that a broker must have a firm understanding of both the product and the customer. It also makes clear that the lack of such an understanding itself violates the Suitability Rule.

Conclusion

As noted above, the new Know Your Customer and Suitability Rules contain several departures from the rules they will be replacing. In light of this fact, brokers should be sure to update their compliance programs and business practices in order to comport with the new rules' requirements. For instance, firms should thoroughly document customer information that is now required to be collected, or, if the information is not collected, the rationale for why the information is not required to be collected for that customer. Additionally, new policies and procedures may need to be developed to incorporate how recommending an "investment strategy" to a customer may now bring a broker within the Suitability Rule's requirements. Accordingly, staff may need to be trained on how to properly develop and document recommendations to customers to help ensure that they have a "reasonable basis" for the recommended investment strategies. Finally, firms should not assume that their existing written supervisory procedures, business practices and compliance programs comport with the new rules' requirements. Firms should carefully review the new rules and consider how the changes impact their existing business practices.

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[14] *See* FINRA Rule 2111.05.