Financial Industry Regulatory Authority

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October 21, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File No. SR-FINRA-2010-039; Response to Comments

Dear Ms. Murphy:

On July 30, 2010, FINRA filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability) in the new consolidated FINRA rulebook. On August 19, 2010, the SEC published FINRA's proposed rule change in the *Federal Register* and sought public comment.[1] On August 26, 2010, the SEC published a corrected notice in the *Federal Register* seeking public comment.[2] The public comment period closed on September 9, 2010. Twenty-two comment letters were submitted. This letter responds to the main issues raised by commenters.[3] FINRA also notes that it filed today with the SEC Amendment No. 1 to SR-FINRA-

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1 *See* Securities Exchange Act Release No. 62718 (Aug. 13, 2010), 75 FR 51310 (Aug. 19, 2010) (Notice of Filing of Proposed Rule Change; SR-FINRA-2010-039). FINRA noted that it essentially was updating the suitability rule by codifying various well-settled interpretations of the rule. FINRA did not narrow any existing suitability obligations via this rule filing.

2 *See* Securities Exchange Act Release No. 62718A (Aug. 20, 2010), 75 FR 52562 (Aug. 26, 2010) (Corrected Notice of Filing of Proposed Rule Change; SR-FINRA-2010-039). The SEC published the correction to rectify various footnoting errors, in large part inadvertent clerical mistakes. *Id.* The corrected notice did not contain substantive changes. *Id.*

3 The proposed rule change originally was published for comment in *Regulatory Notice* 09-25 (May 2009). FINRA received 2,083 comment letters. In its rule filing with the Commission, FINRA provided a detailed discussion of those comments and FINRA's responses thereto. *See* 75 FR 52562, 52565-52574. This letter does not further respond to all of the issues that FINRA previously analyzed and addressed in its original rule filing. This letter also does not respond to issues outside the scope of FINRA's rule filing. For instance, FINRA does not believe it is helpful to discuss the Commission's approval of a Chicago Board Options Exchange proposal to modify certain margin requirements, as one commenter requested.

2010-039, which incorporates changes proposed in response to various comments discussed below.

Request for an Indeterminate Delay of the Proposal

Some commenters again argued that FINRA should delay action on the proposed changes to the "know your customer" and suitability rules.[4] To support their position, they referenced the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), which, among other things, requires the SEC to study broker-dealer and adviser standards of care (with emphasis on a fiduciary duty). These commenters advocated postponing FINRA's rule changes until the parameters of any SEC rulemaking resulting from the study are clear. FINRA believes that such a delay would be inappropriate for a variety of reasons.

FINRA's proposal generally maintains the core features of its current "know your customer" and suitability rules. To the extent that the proposal recommends changes to the rules, those changes would provide greater protection to investors and greater certainty to broker-dealers by streamlining various provisions so that they focus on critical obligations that are not covered by other rules and codifying in one place numerous significant interpretations of key requirements. Nothing in Dodd-Frank argues for the discontinuance of these important sales-practice obligations or the weakening of investor protection generally. FINRA reiterates, moreover, that the suitability and "know your customer" standards are not inconsistent with a fiduciary duty. They are actually a material part of a fiduciary duty in the context of advice or recommendations.[5] Recognizing the importance of the proposal to investor protection, other commenters strongly opposed any delay.[6]

The requested delay also would be problematic because it would amount to an indefinite postponement of the important benefits to customers and broker-dealers noted above. As some commenters opposed to such a delay explained, Dodd-Frank does not require that the Commission engage in rulemaking at the end of its study and, even if the Commission proposes a rule, there is no timetable for doing so.[7]

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[4] *See* Dale E. Brown, President & CEO, Financial Services Institute (Sept. 27, 2010) ("FSI Letter"); Bari Havlik, SVP and Chief Compliance Officer, Charles Schwab & Co., Inc. (Sept. 9, 2010) ("Charles Schwab Letter"); John S. Markle, Deputy General Counsel, TD Ameritrade (Sept. 15, 2010) ("TD Ameritrade Letter"); Pamela Lewis Marlborough, Associate General Counsel, TIAA-CREF (Sept. 9, 2010) ("TIAA-CREF Letter"); James T. McHale, Managing Director and Associate General Counsel, SIFMA (Sep. 14, 2010) ("SIFMA Letter"); Sutherland Asbill & Brennan LLP, on behalf of the Committee of Annuity Insurers (Sept. 9, 2010) ("Committee of Annuity Insurers Letter").

[5] *See* 75 FR 52562, 52567.

[6] *See, e.g.*, Barbara Black, Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law, and Jill I. Gross, Professor of Law and Director, Pace Investor Rights Clinic, Pace University School of Law (Sept. 9, 2010).

[7] *Id.*

Improvements to investor protection and clarification of broker-dealer obligations should not be allowed to stagnate indefinitely simply because there could potentially be a rule that may address similar issues at a future time. As discussed below, however, if the Commission approves the proposal, FINRA is willing to reasonably accommodate the broker-dealers' expressed need for a longer implementation period to develop or modify their systems or procedures to comply with the rule changes.

Know Your Customer

One commenter voiced concern regarding FINRA's proposed elimination of Supplementary Material .20 to NYSE Rule 405, which references the applicability of NYSE Rule 382 (Carrying Agreements) dealing in part with the allocation of responsibility between introducing and carrying firms.[8] Because NASD Rule 3230 (Clearing Agreements) similarly covers allocation issues between introducing and carrying firms and generally would be applicable, reference to NYSE Rule 382 is both outdated and unnecessary.[9]

Suitability

Although commenters raised numerous suitability-related issues that FINRA previously addressed in its original rule filing with the SEC, some comments identified new concerns and some persuaded FINRA to propose minor modifications to the proposal. The comments and FINRA's responses are discussed below.

Consistent Terminology and Expanded Explanations of Key Terms

One commenter stated that FINRA should maintain a standard approach to the terminology used in the rule.[10] The commenter gave as an example the use of "reasonable basis" in one discussion and "reasonable grounds" in another. The commenter also noted that the rule uses both "reasonable diligence" and "adequate due diligence." Another commenter asked FINRA to provide greater clarity in Supplementary Material regarding the terms "investment profile" and "reasonable diligence."[11] In response, FINRA is amending the proposal so that more consistent terminology is used, where possible, and more detailed explanations are provided regarding key terms or responsibilities. As to the latter request, FINRA added expanded discussions regarding a "customer's investment profile" (see discussion below of new Supplementary Material .04 – Customer's Investment Profile) and the

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[8] *See* SIFMA Letter, *supra* note 4.

[9] FINRA is proposing to replace NYSE Rule 382 and NASD Rule 3230 with new consolidated FINRA Rule 4311 (Carrying Agreements), which also generally would be applicable, if approved. *See Regulatory Notice* 09-03 (Jan. 2009).

[10] *See* SIFMA Letter, *supra* note 4.

[11] *See* Committee of Annuity Insurers Letter, *supra* note 4.

"reasonable diligence" standards that are now used in the context of a customer's investment profile (see below) and reasonable-basis suitability.[12]

Information Gathering

Some commenters took issue with various aspects of the proposal's information-gathering requirements. The proposal includes an expanded list of explicit information that members and associated persons would have to attempt to gather and analyze when making recommendations. At present, the suitability rule generally requires that broker-dealers and associated persons attempt to gather information about and analyze the customer's other security holdings, financial situation and needs, financial status, tax status, investment objectives, and such other information used or considered to be reasonable by such member or associated person in making recommendations to the customer. FINRA expanded that list to include the customer's age, investment experience, investment time horizon, liquidity needs, and risk tolerance.

Several commenters stated that obtaining each specified category of information is not warranted on every occasion.[13] They asked that FINRA build flexibility into the rule so that a firm would not have to collect information if it was irrelevant based on the particular facts and circumstances.[14] If FINRA does require firms to obtain and capture this information, these commenters requested that FINRA establish an effective date for the new rule that recognizes the difficulty associated with developing, modifying, and implementing forms and systems to request and capture the proposed new categories of information.[15]

In addition, one commenter argued that factors such as a customer's investment experience, time horizon, and risk tolerance are ones to be considered when reviewing a customer's portfolio as a whole, not the individual trades.[16] According to this commenter, requiring consideration of such factors on a trade-by-

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12 The Supplementary Material regarding reasonable-basis suitability now contains the following expanded discussion of the term "reasonable diligence": "A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule."

13 *See* Charles Schwab Letter, *supra* note 4; Committee of Annuity Insurers Letter, *supra* note 4; SIFMA Letter, *supra* note 4; TD Ameritrade Letter, *supra* note 4; TIAA-CREF Letter, *supra* note 4.

14 *See, e.g.*, Committee of Annuity Insurers Letter, *supra* note 4; TD Ameritrade Letter, *supra* note 4; TIAA-CREF Letter, *supra* note 4.

15 *See* Charles Schwab Letter, *supra* note 4; Committee of Annuity Insurers Letter, *supra* note 4; SIFMA Letter, *supra* note 4; TD Ameritrade Letter, *supra* note 4; TIAA-CREF Letter, *supra* note 4.

16 *See* FSI Letter, *supra* note 4.

trade basis would prevent customers from creating a diverse portfolio made up of securities with different levels of liquidity, risk, and time horizons.[17]

It is important to note that FINRA did not cut these factors from whole cloth. By and large, they are subsets of the broader categories of information identified in the current suitability rule. Case law and regulatory notices have long stressed the significance of these factors to a suitability analysis.[18] FINRA believes it would be helpful to explicitly list in one place the main factors that generally have been viewed as relevant to a suitability analysis.

That does not mean that every factor will be a crucial or even necessary consideration in every case. The level of importance of each category of customer information may vary depending on the facts and circumstances of the particular case. There may be limited circumstances where certain factors are irrelevant to the analysis (e.g., the customer's age in the context of accounts held by non-natural persons).

In response to those comments requesting flexibility regarding the type of information that firms must seek to obtain and comments requesting more guidance on

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17 *Id.*

18 *See, e.g., Steven E. Muth*, Securities Exchange Act Release No. 52551, 2005 SEC LEXIS 2488 (Oct. 3, 2005) (focusing largely on customers' risk tolerance in finding that recommendations were unsuitable); *David Lerner Assoc., Inc.*, Securities Exchange Act Release No. 49729, 2004 SEC LEXIS 1025 (May 19, 2004) (considering liquidity needs in finding recommendation unsuitable); *J.W. Barclay & Co.*, Securities Exchange Act Release No. 47611, 2003 SEC LEXIS 762, at *3 (April 1, 2003) (stating that respondent recommended "securities that were not suitable for the customer in light of the customer's age, investment experience, financial status, risk tolerance and investment objectives"); *James B. Chase*, 56 S.E.C. 149 (2003) (considering customer's lack of investment experience as one factor leading to conclusion that recommendation was unsuitable); *Gordon Scott Venters*, 51 S.E.C. 292 (1993) (finding that respondent made unsuitable recommendation in light of customer's age and investment experience, among other things); *Dep't of Enforcement v. Kesner*, No. 2005001729501, 2010 FINRA Discip. LEXIS 2 (Feb. 26, 2010) (emphasizing importance of a customer's risk tolerance and investment objectives when making recommendations); *Dep't of Enforcement v. Zaragoza*, No. E8A2002109804, 2008 FINRA Discip. LEXIS 28 (Aug. 20, 2008) (considering customer's age, investment experience, investment objectives, and financial situation in resolving suitability claim); *Dep't of Enforcement v. Epstein*, No. C9B0400098, 2007 FINRA Discip. LEXIS 18 (Dec. 20, 2007) (explaining that brokers must consider, among other things, the customer's investment objectives, liquidity needs, risk tolerance, and investment time horizon before making recommendations), *aff'd*, Securities Exchange Act Release No. 59328, 2009 SEC LEXIS 217 (Jan. 30, 2009); *DBCC v. Klein*, No. C01940014, 1995 NASD Discip. LEXIS 222 (June 26, 1995) (considering customers' age, investment experience, risk tolerance, and investment objectives in determining suitability), *aff'd*, 52 S.E.C. 1030 (1996); *DBCC v. Baune*, No. C05920109, 1994 NASD Discip. LEXIS 17 (Aug. 4, 1994) (illiquid investments unsuitable for customer); *Notice to Members* 00-44 (July 2000) (emphasizing need to obtain comprehensive customer information, including customer's time horizon); *Notice to Members* 95-80 (Sept. 1995) (noting importance of analyzing, among other things, a customer's liquidity needs and risk tolerance); *Regulatory and Compliance Alert* (Summer 2000) (noting that a customer's time horizon is an important consideration when determining suitability of a recommended mutual fund investment).

what is required, FINRA is amending the proposal by adding the following new Supplementary Material:

> **.04 Customer's Investment Profile.** A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.

Because the factors discussed in Rule 2111(a) generally are relevant (and often crucial) to a suitability analysis, the rule would require firms to document with specificity their reasonable basis for believing that a factor is irrelevant in order to be relieved of the obligation to seek to obtain information about that factor.[19] FINRA also created another Supplementary Material to Rule 2111 that reiterates FINRA's longstanding position that firms and associated persons cannot disclaim any obligations under the suitability rule.[20] Among other things, that Supplementary Material would make clear that firms and associated persons cannot disclaim their obligations to seek to obtain and analyze relevant customer information.

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[19] FINRA notes that the efforts of a firm that seeks but does not obtain information about a particular factor (as opposed to a situation where the firm does not attempt to obtain the information in the first instance) would be judged by the "reasonable diligence" standard. FINRA also notes that, when customer information is unavailable despite a firm's reasonable diligence in seeking to obtain the information, the firm must carefully consider whether it has sufficient customer information to properly evaluate the suitability of a recommendation to the customer. However, if the firm used reasonable diligence, the absence of some customer information that is not critical to the analysis based on the facts and circumstances of the particular case generally would not preclude a recommendation from being viewed as suitable as long as the broker had obtained and analyzed other customer information that provided the broker with a reasonable basis to believe that the recommendation was suitable for that customer.

[20] *See, e.g., Notice to Members* 01-23 (April 2001) ("[A] broker/dealer cannot disclaim away its suitability obligations....").

The comment stating that the additional factors should be evaluated based on the customer's "investment portfolio" and "not on a transaction-by-transaction basis"[21] raises a different issue. The commenter voiced concern that consideration of the additional factors on a "transaction-by-transaction basis" would somehow prevent customers, in all circumstances, from creating a diverse portfolio made up of securities with different levels of liquidity, risk, and time horizons.[22] FINRA disagrees with the premise that a recommendation-by-recommendation analysis and consideration of a customer's investment portfolio are somehow mutually exclusive concepts. Although suitability is a recommendation-by-recommendation analysis, the current and proposed rules explicitly permit the suitability analysis to be performed within the context of the investor's other security holdings or investments. Moreover, both the current and proposed rules cover recommended investment strategies.

In regard to the request for a delay in the implementation date, FINRA appreciates that, notwithstanding its amendment to add flexibility to the information gathering requirements, some firms may still need to develop or modify forms and systems to request and capture some of the proposed additional explicit categories of information. Consequently, FINRA will announce the implementation date of the proposed rule change in a *Regulatory Notice* to be published no later than 60 days following Commission approval, with an implementation date 270 days following publication of the *Regulatory Notice* announcing Commission approval.

Recommendations to Hold

Numerous commenters requested that FINRA state in the rule language that the rule covers explicit recommendations to hold a security or securities.[23] FINRA previously stated that the elimination in the proposed rule of the "purchase, sale or exchange" language used in the current rule and the addition in the proposed rule of the term "strategy" meant that the proposed suitability rule would cover explicit recommendations to hold a security or securities.[24] FINRA explained that the rule recognizes that customers may rely on members' and associated persons' investment

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21 *See* FSI Letter, *supra* note 4.

22 *Id.*

23 *See, e.g.*, G. Mark Brewer, Esq., Investment Recovery Counsel (Sept. 9, 2010); Lisa Catalano, Director, St. John's University School of Law Securities Arbitration Clinic (Sept. 9, 2010); Barry D. Estell, Esq. (Sept. 9, 2010); Scott C. Ilgenfritz, Esq., Johnson, Pope, Bokor, Ruppel & Burns, LLP (Sept. 24, 2010); William A. Jacobson, Director, Cornell Law School Securities Law Clinic (Sept. 9, 2010); Stephen Krosschell, Goodman Nekvasil, P.A. (Sept. 9, 2010); Richard M. Layne (Sept. 9, 2010); Peter J. Mougey, Levin, Papatonio, Thomas, Mitchell, Echsner, Rafferty, Proctor, P.A. (Sept. 9, 2010); David P. Neuman, Stoltmann Law Offices, PC (Sept. 9, 2010); Scott R. Shewan, President, Public Investors Arbitration Bar Association (Sept. 9, 2010); Al Van Kampen, Esq. (Sept. 10, 2010).

24 *See* 75 FR 52562, 52568. As discussed in the original rule filing, the rule would *not* cover *implicit* recommendations to hold a security or securities. *Id.*

expertise and knowledge, and it is thus appropriate to hold members 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.[25]

Notwithstanding this discussion in FINRA's original rule filing, a number of commenters expressed concern over possible future confusion caused by an omission of the term "hold" from the actual rule language. In light of these concerns, FINRA proposes to make clear in the Supplementary Material that the rule covers an *explicit* recommendation to hold a security or securities.

Institutional Customer

The main focus of the proposed institutional-customer exemption to the suitability rule (Rule 2111(b)) is whether the broker has a reasonable basis to believe the customer is capable of analyzing the risks of investments and whether the institutional customer affirmatively acknowledges that it is exercising independent judgment. A firm that satisfies the conditions delineated in proposed Rule 2111(b) would fulfill its customer-specific obligation, but not its reasonable-basis and quantitative obligations under the suitability rule.[26]

One commenter requested that FINRA exempt from the "affirmatively acknowledge" requirement those institutions that are qualified institutional buyers ("QIBs") for purposes of Rule 144A under the Securities Act of 1933 ("Securities Act"), which deals with application of Section 5 of the Securities Act (but not antifraud or other provisions of the securities laws) to private resales of securities to institutions.[27] The main thrust of the commenter's argument appears to be that an entity that owns and invests on a discretionary basis at least $100 million in securities of non-affiliated issuers (an entity generally meets the QIB definition under such circumstances) should not have to provide the affirmative acknowledgment. FINRA does not believe that a monetary threshold, whatever the amount or context, is an adequate substitute for the proposed requirement that the institutional customer affirmatively acknowledge that it is exercising independent judgment as part of the determination that an exemption from customer-specific suitability applies.

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[25] *Id.*

[26] There are three main suitability obligations: (1) reasonable basis (members must have a reasonable basis to believe, based on reasonable diligence, that a recommendation is suitable for at least *some* investors); (2) customer specific (members must have a reasonable basis to believe a recommendation is suitable for the particular investor at issue); and (3) quantitative (members must have a reasonable basis to believe the number of recommended transactions within a certain period is not excessive). *See* 75 FR 52562, 52564 & 52573-52574.

[27] *See* SIFMA Letter, *supra* note 4.

The same commenter also asked FINRA to expand the coverage of the institutional customer exemption so that, in addition to meeting its customer-specific obligation, a firm also meets its quantitative suitability obligation if the conditions in Rule 2111(b) are satisfied.[28] The commenter states that "[n]o one firm is seeing all the trades, nor is any one firm seeing the institution's entire investment portfolio, because they do not maintain custody of all assets."[29] FINRA believes that it is important that a firm not recommend an unsuitable number of transactions in those circumstances where it has control over the account. FINRA emphasizes, however, that quantitative suitability generally would apply only with regard to that portion of an institutional customer's portfolio that the firm controls and only with regard to the firm's recommended transactions.[30]

In addition, the commenter requested that FINRA modify the following Supplementary Material discussion: "[A]n institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account." The

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[28] *Id.*

[29] *Id.*

[30] It is axiomatic that the suitability rule applies only to recommended transactions. *See, e.g., Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *46 (July 30, 2009) (explaining that transactions that were not recommended could not be used to inflate the cost-to-equity ratio and the turnover rate). FINRA notes, however, that FINRA and the SEC have held that associated persons who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule. *See, e.g., Rafael Pinchas*, 54 S.E.C. 331, 341 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992) (stating that transactions broker effects for a discretionary account are implicitly recommended).

Case law also has long established that quantitative suitability "occurs when a registered representative has control over trading in an account and the level of activity in that account is inconsistent with the customer's objectives and financial situation." *Harry Gliksman*, 54 S.E.C. 471, 475 (1999), *aff'd*, 24 F. App'x 702 (9th Cir. 2001); *see also Pinchas*, 54 S.E.C. at 337 (same). In general, the control element "is satisfied if the broker has either discretionary authority or de facto control over the account. De facto control is established when the client routinely follows the broker's advice 'because the customer is unable to evaluate the broker's recommendations and to exercise independent judgment.'" *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34 (citations omitted).

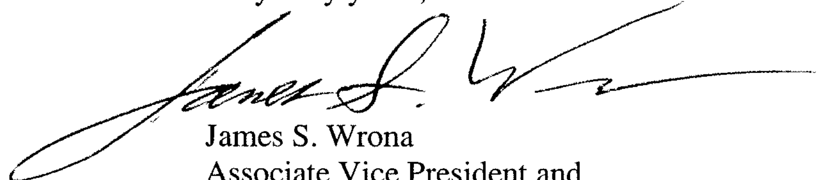
In *Pryor, McClendon, Counts & Co.*, Securities Exchange Act Release No. 45402, 2002 SEC LEXIS 284 (Feb. 6, 2002), the Commission analyzed allegations of churning by focusing on that portion of the city of Atlanta's portfolio that the broker-dealer respondent controlled and those transactions that the respondent recommended. *Id.* at *4, *15-16, *20-23. The Commission also held that, for purposes of churning, the respondent controlled the portion of Atlanta's portfolio at issue because the respondent engaged in a scheme to defraud Atlanta with the city's investment officer, who had authority to trade Atlanta's securities portfolio. *Id.* at *20-21 (citing *Smith v. Petrou*, 705 F. Supp. 183, 187 (S.D.N.Y. 1989)).

commenter stated that the Supplementary Material is confusing and likely was intended simply to allow member firms to establish and document a clear understanding of the institutional customer's independence at the outset of the relationship (i.e., at the time of account opening). The commenter stated that if FINRA intended the Supplementary Material to give institutional customers the ability to require member firms to capture changing affirmative indications on a trade-by-trade basis, the provision will fundamentally alter the operation of the institutional markets and could have a negative impact on execution quality.

FINRA's intent was, as FINRA believes the Supplementary Material makes clear, to allow an institutional investor to indicate that it is "exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account." If a broker-dealer believes that such action on a trade-by-trade basis would fundamentally change its operations, it is free to decide as a business matter to service only those institutional investors that are willing to make the affirmative indication in terms of all potential transactions for its account.

FINRA believes that the foregoing, along with the discussion in the original rule filing, fully responds to the issues raised by commenters. If you have any questions, please contact me at 202-728-8270.

Very truly yours,



James S. Wrona
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cc: Lourdes Gonzalez, Esq.
Bonnie L. Gauch, Esq.