FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

June 19, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-13 | FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111 (Notice)

Dear Ms. Mitchell:

On April 20, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on proposed amendments (Proposed Amendments) to FINRA Rule 2111(Suitability). FINRA Rule 2111 establishes firms' and advisors' suitability obligations and, among other things, codifies case law concerning excessive trading - a practice that is also referred to as "churning."[1] In particular, supplementary material .05 of FINRA Rule 2111, imposes a quantitative suitability obligation on FINRA's members. That obligation summarily requires firms and advisors to have "a reasonable basis for believing that a series of recommended transactions" are suitable and not excessive, in light of the customer's investment objectives.[2]

Under the current iteration of FINRA Rule 2111, advisors' and firms' quantitative suitability obligation is triggered only if the advisor, or the firm, has control over the customer's account. Under the Proposed Amendments, that obligation would be triggered where the advisor or the firm recommends a series of transactions, regardless of whether the advisor controls the account.[3] FINRA's decision to eliminate the "control" component from the quantitative suitability obligation is predicated upon: (a) its experience with this aspect of the rule; as well as (b) FINRA's desire to align its rules with the Securities and Exchange Commission's (SEC's) proposed Regulation Best Interest (SEC Regulation Best Interest).[4]

[1] See FINRA Regulatory Notice 18-13 (April 20, 2018) at p. 2, available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-13.pdf (Notice); see also FINRA Rule 2111 (Suitability) FAQs, at Q6.1 & A6.1, available at http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

[2] *Id.*; see also FINRA Rule 2111 (Suitability) FAQs, at Q6.1 & A6.1, available at http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

[3] *See, generally,* Notice.

[4] See Notice at p. 2.

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The Financial Services Institute[5] (FSI) appreciates the opportunity to comment on this important proposal. While FSI is still formulating its comments in response to SEC Regulation Best Interest, FSI believes that advisors should act in the best interest of their clients and that SEC Regulation Best Interest is a positive step toward industry stakeholders reaching a consensus regarding what that means. FSI further believes that, where practicable, laws and regulations pertaining to the same class of persons, should be harmonized. Also, most important to FSI and its members, the Proposed Amendments heighten investor protection.

FSI notes that the Proposed Amendments may lead to a substantial increase in churning cases and resulting enforcement actions. Nonetheless, we believe this potential is substantially outweighed by investor protection considerations. Thus, FSI supports FINRA's proposal.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.[6] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).[7]

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.[8]

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[5] The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.
[6] Cerulli Associates, Advisor Headcount 2016, on file with author.
[7] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.
[8] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

Discussion

FSI appreciates the opportunity to comment on FINRA's proposal. As noted above, FSI supports the proposal as an important attempt to harmonize the laws and rules governing firm's and advisor's obligations and, in particular, the standard of care that advisors should exercise when recommending a series of securities transactions. FSI, however, notes that this proposal lowers the bar for regulators to bring excessive trading cases against firms and advisors. Moreover, for churning cases brought under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 (Exchange Act), the proposal may have the unintended consequence of more advisors or firms being statutorily disqualified. These concerns are discussed in greater detail below.

I. FSI Supports FINRA's Rule Proposal

A. Introduction and Background

In 2011, the SEC approved FINRA's proposal to amend its suitability rules to, among other things, create three categories of suitability obligations.[9] Those categories, which are encompassed in the current iteration of the rule, are reasonable basis suitability, customer specific suitability, and quantitative suitability.[10] Specific to the Proposed Amendments, the latter category requires that:

> "…a member or associated person 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 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."[11]

Whether an advisor has actual control over a customer's account is relatively clear. An advisor who has discretionary authority over the customer's account has actual control of the account.[12] However, *de facto* control is a concept largely established by case law,[13] that requires a facts and circumstances analysis, and is thus less clear and open to multiple interpretations. More specifically, an advisor has *de facto* control over a customer's account where the customer routinely follows the advisor's advice, the customer is unable to evaluate

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[9] *See* FINRA Regulatory Notice 11-02 (Regulatory Notice 11-02) at fn. 11, citing Dane S. Faber, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (February 10, 2004), available at http://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf

[10] See FINRA Rule 2111, Sup. Mat. 05 (a) – (c).

[11] See FINRA Rule 2111, Sup. Mat. 05 c).

[12] See FINRA Dep't of Enforcement v. Medeck, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *34(July 30, 2009).

[13] *See* Notice at p. 2.

that advice and the customer the customer is unable to utilize his or her independent judgement.[14]

B. FSI Supports the Proposed Amendments

i. The Proposed Amendments Attempt to Harmonize Advis or's Regulatory Obligations

The Proposed Amendments, like the SEC's Regulation Best Interest proposal, would apply to advisor's quantitative suitability obligations, regardless of whether the advisor had actual or *de facto* control over the customer's account.[15] FSI supports the Proposed Amendments because while the final version of SEC Regulation Best Interest may vary from the SEC's pending proposal, the Proposed Amendments are a step towards harmonizing advisors' obligations when recommending a series of transactions to customers. This harmonization is something that FSI has long since supported. Specifically, FSI believes that compliance is substantially more efficient and effective when regulators create a regulatory environment that enables advisors and firms to operate under a clear, concise and uniform (or, at least, substantially similar) set of rules.

Notably, FINRA guidance has previously pointed out that an advisor's recommendations should be in a customer's best interest.[16] In fact, FINRA has advised that, "the suitability rule and the concept that a broker's recommendation must be consistent with the customer's best interests are inextricably intertwined."[17] FINRA has also clarified that acting in a customer's best interest does not require firms or advisors to offer the least expensive security.[18] Instead, it only necessitates that the recommendation be suitable in light of the customer's investment objectives.[19] If adopted, those concepts would, in many respects, be codified in SEC Regulation Best Interest.

ii. The Proposed Amendments Heighten Investor Protection

Under the Proposed Amendments, an advisor's or firm's suitability obligations would be triggered at the time the advisor recommends a series of securities transactions. Fundamentally, this change comports with the basic guiding principles of FINRA Rule 2111, i.e., holding advisors to a specific standard of care where they recommend securities transaction versus when the

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[14] *See* Medeck, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *34.
[15] *See, e.g.,* S.E.C. Release No. 34-83062; File No. S7-07-18 (April 18, 2018) at p. 150 (stating that the SEC believes "it is appropriate to incorporate this existing, well-established obligation, which would … promote consistency and clarity regarding this obligation. However, [the SEC believes] it is appropriate to expand the scope of this requirement by applying it irrespective of whether a broker-dealer exercises actual or de facto control over a customer's account, thereby making the obligation consistent with the current requirements for "reasonable basis suitability" and "customer specific suitability." Accordingly, [SEC] Regulation Best Interest would include the existing "quantitative suitability" obligation, but without a "control" element.")
[16] *See* Regulatory Notice 11-02 at fn. 11, citing Dane S. Faber, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (February 10, 2004; *see also* SEC Staff Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, at p. 59 (Jan. 2011) (IA/BD Study), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf.
[17] *See* FINRA Regulatory Notice 12-25, pp. 3-4 (May 2012) (explaining that "[t]he suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests."), available at http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_25.pdf.
[18] *Id.*
[19] *Id.*

investor decides to, independently, engage in a securities transaction. Thus, FSI believes the Proposed Amendments heighten investor protection.[20]

C. Investor Protection Considerations Outweigh the Unintended Collateral Consequences of the Proposed Amendments

By eliminating the control element of advisors' and firms' quantitative suitability obligations, the standard of proof for churning cases will be substantially lower. Thus, the proposal may result in more churning cases than would otherwise be brought, resulting in more fines, penalties and awards being assessed against firms and advisors. Moreover, additional adverse findings of churning, specifically those resulting in findings that the firm or advisor willfully violated Section 10(b) and Rule10b-5 of the Exchange Act, may lead to more firms and advisors becoming statutory disqualified. However, FSI notes that this potential uptick of findings of churning, and the resulting consequences, are substantially outweighed by heightened investor protection and reducing the potential for advisors and firms to be subject to varying standards of care when recommending a series of securities transactions.

FSI does, however, encourage FINRA to look back at the Proposed Amendments, within three to five years of them becoming effective, to assess whether the Proposed Amendments are consistent with the version of SEC Regulation Best Interest that is ultimately adopted. That look back should also consider whether implementation and enforcement of the Proposed Amendments are achieving the Proposed Amendments' regulatory objective.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,

Vice President, Regulatory Affairs & Associate General Counsel

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[20] See FINRA Letter of Acceptance, Waiver and Consent, No. 2014043542408 between FINRA Dep't of Enforcement and David Awad (September 14, 2015), available at http://www.finra.org/sites/default/files/Awad_AWC_091515.pdf.