Regulatory Notice 18-13

April 20, 2018

Notice Type
- Request for Comment

Suggested Routing
- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics
- Excessive Trading
- Quantitative Suitability
- Suitability

Referenced Rules & Notices
- FINRA Rule 2111
- Notice to Members 01-23
- Regulatory Notice 11-02
- Regulatory Notice 11-25
- Regulatory Notice 12-25

Quantitative Suitability

FINRA Requests Comment on Proposed Amendments to the Quantitative Suitability Obligation Under FINRA Rule 2111

Comment Period Expires: June 19, 2018

Summary

FINRA seeks comment on proposed rule amendments that would revise the quantitative suitability obligation under FINRA Rule 2111 (Suitability) to more effectively address instances of excessive trading in customers' accounts. The proposed rule amendments would remove the element of control that currently must be proved to demonstrate a violation, but would not change the obligations to prove that the transactions were recommended and that the level of trading was excessive and unsuitable in light of the customer's investment profile.

The proposed rule text is available in Attachment A.

Questions regarding this *Notice* should be directed to:

- James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270; or
- Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by June 19, 2018.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

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To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[1]

Before becoming effective, the proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).[2]

Background & Discussion

In 2010, when FINRA amended its longstanding suitability rule, it codified the line of cases on excessive trading (sometimes referred to as "churning") as the rule's quantitative suitability obligation.[3] Consistent with the case law, FINRA's quantitative suitability obligation requires a broker who has control over a customer's account to have a reasonable basis for believing that a series of transactions the broker recommends is not excessive and unsuitable for the customer, even if the individual transactions are suitable when viewed in isolation. However, if a broker does not control a customer's account, the quantitative suitability obligation does not apply when the broker recommends a series of transactions, even if that series of transactions is excessive and unsuitable for the customer. FINRA has reconsidered the appropriateness of the control element in light of its experience with the rule, the other requirements of the rule and, more recently, the SEC's proposed Regulation Best Interest (Regulation BI).[4] FINRA seeks comment on its proposal to amend Supplementary Material .05(c) of Rule 2111 to remove the control element from the quantitative suitability obligation.

A. Actual or De Facto Control Under Quantitative Suitability

Under the quantitative suitability obligation, control can be actual or de facto. In general, actual control exists when a broker has formal discretionary authority over a customer's account.[5] A showing of de facto control over a customer's account depends on whether the customer routinely follows the broker's advice because the customer is unable to evaluate the broker's recommendations and exercise independent judgment.[6] In practice, however, these assessments can be difficult to make and they place a heavy and unnecessary burden on customers by, in effect, asking them to admit that they lack sophistication or the ability to evaluate a broker's recommendations. This is true even where it is otherwise clear that the broker recommended the transactions and that they were excessive and unsuitable. FINRA is concerned that the control element serves as an impediment to investor protection and an unwarranted defense to unscrupulous brokers.

B. Proposed Amendments

The proposed amendments would remove the phrase "who has actual or de facto control over a customer account" from the quantitative suitability obligation under Supplementary Material .05(c) of Rule 2111. The original basis for requiring the control element is unnecessary under the suitability rule. The inclusion of the control element has its historic roots, in part, in the perceived need to ensure that the culpability for excessive trading rested with the party responsible for initiating the transactions in actions brought pursuant to the antifraud provisions of the federal securities laws.[7] That concern is not present under FINRA's suitability rule. Because FINRA must show that the broker *recommended* the transactions in order to prove a Rule 2111 violation, culpability for excessive trading will still rest with the appropriate party even absent the control element.[8] Moreover, the existence of the control element may impede investor protection by acting as an unintended shield for unscrupulous brokers engaged in excessive trading. Indeed, as the SEC noted in proposing Regulation BI, "the fact that a customer may have *some* knowledge of financial markets or *some* 'control' should not absolve the broker-dealer of its ultimate responsibility to have a reasonable basis for any recommendations that it makes."[9]

Finally, the proposed rule would continue to require FINRA to prove that the series of recommended transactions was excessive and unsuitable, and the proposed amendments would not affect the extensive case law concerning whether trading activity is excessive. Whether trading activity in a customer's account is excessive would still depend on the facts and circumstances of a particular case and would continue to be assessed in light of the customer's investment profile.[10] Although no single test defines excessive activity, factors such as turnover rate,[11] cost-to-equity ratio[12] or the use of in-and-out trading[13] may provide a basis for a finding of excessive trading.[14] A turnover rate of six or a cost-to-equity ratio above 20 percent generally is indicative of excessive trading.[15] However, lower ratios have supported findings of excessive trading for customers with very conservative investment objectives,[16] while somewhat higher ratios have not supported findings of excessive trading for some customers with highly speculative investment objectives and the financial resources to withstand potential losses.[17] In addition to these ratios, a pattern of in-and-out trading in relatively short periods of time is a "hallmark" of excessive trading, which, by itself, can provide a basis for finding excessive trading.[18]

Economic Impact Assessment

A. Economic Baseline

The economic impact of the proposed rule is dependent on the effects of removing the control element from the quantitative suitability obligation. The control element in the current rule makes it difficult to enforce the quantitative suitability obligation, even where the excessiveness of the trading and the broker's responsibility for the recommendations are clear. As a result, brokers may be able to recommend excessive levels of trading to their customers but avoid disciplinary actions for violating the quantitative suitability obligation because of the difficulty in assessing and proving de facto control over their customers' accounts.

B. Economic Impact

The proposed amendment to Rule 2111 would promote investor protection. Removing the control element from the quantitative suitability obligation would likely increase FINRA's ability to hold brokers responsible for recommendations resulting in excessive trading and serve as a deterrent to possible future misconduct.

As a general proposition, a potential impact of reducing the threshold for establishing a violation of any rule may be that it increases the probability of establishing a violation in the presence of less evidence. However, FINRA does not believe the removal of the control element would lead to disciplinary actions against brokers for excessive trading when the brokers are not responsible for initiating the transactions. In the absence of the control element, FINRA's suitability rule will continue to require FINRA to prove that the broker recommended the transactions and that the transactions were excessive and unsuitable in light of the customer's investment profile. These elements ensure that the culpability for excessive trading continues to rest with the appropriate party. The control element is an unnecessary layer of proof regarding the identity of the responsible party (*i.e.*, the party initiating the transactions) and does not in any way touch on the proof needed to establish the underlying, substantive misconduct (*i.e.*, the excessive trading activity inconsistent with the customer's investment profile).

FINRA believes, moreover, that the proposed change would impose minimal, if any, additional compliance burdens on members because FINRA understands that firms already routinely perform compliance reviews for excessive trading activity without consideration of whether a broker controls the account. The primary cost may be that member firms would need to update written supervisory procedures.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following questions:

1. How does your firm currently monitor for potentially excessive trading in customer accounts? Does your firm consider whether brokers have de facto control over customers' accounts when monitoring for potential excessive trading? If so, how does your firm conduct such monitoring?
2. The proposal would remove the element of control from the quantitative suitability obligation. Would the requirement to prove that the transactions were *recommended* continue to ensure that the culpability for excessive trading rests with the appropriate party?
3. Are there alternative ways to address excessive trading that should be considered? If so, what are the alternative approaches that FINRA should consider?
4. Are there any material economic impacts, including costs and benefits, to investors, brokers and firms that could result from implementation of the proposed amendments?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.

2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. *See Regulatory Notice 12-25*, at 14 (May 2012). Although the terms "churning" and "excessive trading" are often used interchangeably, churning requires scienter in order to prove a fraud, whereas "excessive trading," now known as quantitative suitability, does not. *See David A. Roche*, 53 S.E.C. 16, 22 (1997).

4. On April 18, 2018, the SEC proposed Regulation Best Interest, which would create a new rule under the Exchange Act and establish a "best interest" standard of conduct for broker-dealers and associated persons when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. *See* Regulation Best Interest, Exchange Act Release No. 83062 (Apr. 18, 2018) (Regulation BI Proposing Release). One element of the multi-pronged approach proposed by the SEC would incorporate and go beyond existing suitability obligations under the federal securities laws and FINRA Rule 2111. *Id.* at 10. In incorporating a prohibition on excessive trading, the SEC expressly excluded the "control" element currently present in FINRA's quantitative suitability rule, noting that the SEC proposed requirement would apply irrespective of whether a broker-dealer exercises actual or de facto control over a customer's account. *Id.* at 150. As a result, in order to satisfy the best interest standard, the SEC proposal would require that a broker-dealer or associated person exercise reasonable diligence, care, skill, and prudence to, among other things, have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile. *Id.* at 133. The SEC's decision to eliminate the "control" element from its proposal is consistent with FINRA's proposed amendment to the quantitative suitability obligation described herein. FINRA notes, as well, that it will consider the potential impact of Regulation BI, if adopted, on FINRA's suitability rule more generally.

5. *See Peter C. Bucchieri*, 52 S.E.C. 800, 805 n.11 (1996). Where a broker exercises discretion over an account or engages in unauthorized trading, he or she is viewed as having implicitly recommended the transactions. *See Dep't of Enforcement v. Murphy*, No. 2005003610701, 2011 FINRA Discip. LEXIS 42, *42 n.33 (NAC Oct. 20, 2011) ("Any violation of the suitability rule also requires proof that there was a 'recommendation.' When a broker exercises discretion to make trades or engages in unauthorized trading, . . . such trades are considered to be implicitly recommended for purposes of the suitability rule.").

6. *See Harry Gliksman*, 54 S.E.C. 471, 475 (1999).

7. *See E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 380 (1945) (stating that a broker "cannot be held guilty of overtrading in an account where transactions are initiated by the customer" and that, with regard to excessive trading liability under the antifraud provisions of the Exchange Act, the question is whether the broker occupied "such a status with respect to the customer that he may be held responsible for excessive trading in such customer's account").

8. Although FINRA has not defined "recommendation," FINRA has provided several guiding principles through past *Notices* that are relevant to the analysis. *See*, *e.g.*, *Regulatory Notice 12-25; Regulatory Notice 11-02* (January 2011); *Regulatory Notice 01-23* (April 2001). These guiding principles remain applicable for the determination of a recommendation under the proposed amendments to the quantitative suitability obligation.

9. Regulation BI Proposing Release, *supra* note 4, at 155.

10. *See Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at *40-41 (May 27, 2011), *aff'd sub. nom.*, *Cody v. SEC*, 693 F.3d 251 (1st Cir. 2012).

11. Turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." *Rafael Pinchas*, 54 S.E.C. 331, 339-40 n.14 (1999).

12. The cost-to-equity ratio represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses." *Id.* at 340.

13. In-and-out trading refers to the "sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities." *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).

14. *See Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, *34 (NAC July 30, 2009).

15. *See Howard*, 55 S.E.C. at 1100-01 ("While there is no definitive turnover rate or cost-to-equity ratio that establishes excessive trading, a turnover rate of 6 or a cost-to-equity ratio in excess of 20% generally indicates that excessive trading has occurred."); *Pinchas*, 54 S.E.C. at 340 (recognizing that "a cost-to-equity ratio in excess of 20% indicates excessive trading"); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980) (recognizing that "an annual turnover rate of six reflects excessive trading"); *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith*, 767 F.2d 1498, 1502 (11th Cir. 1985) (same); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 (6th Cir. 1990) (same).

16. Turnover rates between three and six may trigger liability for excessive trading, depending on the facts and circumstances. *See Cody*, 2011 SEC LEXIS 1862, at *51 (finding turnover rate of 3.21 to be excessive given customers' conservative investment objectives); *Dep't of Enforcement v. Stein*, No. C07000003, 2001 NASD Discip. LEXIS 38, at *17 (NAC Dec. 3, 2001) ("Turnover rates between three and five have triggered liability for excessive trading"), *aff'd sub. nom.*, *Jack H. Stein*, 56 S.E.C. 108 (2003). Even turnover rates below three may provide a basis for finding excessive trading. *See Sandra K. Simpson*, 55 S.E.C. 766, 794 (2002) (finding turnover rate as low as 2.10 provided support that trading was excessive for customers with conservative investment objectives); *Jenny v. Shearson, Hammill & Co.*, 1978 U.S. Dist. LEXIS 15077, at *6 (S.D.N.Y. Oct. 6, 1978) (refusing to hold, as a matter of law, that a turnover rate of 1.84 cannot be excessive for any account). In addition, cost-to-equity ratios as low as 8.7 percent have been considered indicative of excessive trading and ratios above 12 percent generally are viewed as strong evidence of excessive trading. *See Cody*, 2011 SEC LEXIS 1862, at *49 and *55 (finding cost-to-equity ratio of 8.7 percent excessive); *Thomas F. Bandyk*, Exchange Act Release No. 35415, 1995 SEC LEXIS 481, at *2–3 (Feb. 24, 1995) (finding cost-to-equity ratios ranging between 12.1 percent and 18 percent excessive).

17. *See DBCC v. Zandford*, No. WA-530, 1989 NASD Discip. LEXIS 39, *21 (DBCC June 7, 1989) (finding that a turnover rate of 9.6 was not excessive under the unique facts of the case, including that the customers had highly speculative investment objectives and financial resources such that they could withstand potential losses).

18. *See Howard*, 55 S.E.C. at 1100-01; *Pinchas*, 54 S.E.C. at 339.

Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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2000. DUTIES AND CONFLICTS

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2100. TRANSACTIONS WITH CUSTOMERS

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2110. Recommendations

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2111. Suitability

(a) through (b) No Change.

• • • Supplementary Material: --------------

.01 through .04 No Change

.05 Components of Suitability Obligations. Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) through (b) No Change.

(c) Quantitative suitability requires 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 <u>the member or associated person recommended to the customer account</u>, 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.

.06 through .07 No Change.