

From: Mike Hogan [hoganm@foliofn.com]
Sent: Monday, June 29, 2009 1:35 PM
To: Comments, Public
Cc: Jeff Smith; Steve Wallman; Aaron Gonzales
Subject: FOLIOfn Investments, Inc. Comments on Regulatory Notice 09-25 Suitability and "Know Your Customer"

Attachments: Microsoft Word - Suitability Comment Letter - SENT 6-29-09.pdf



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Suitability C...

Attached is FOLIOfn Investments, Inc's comment to Regulatory Notice 09-25 Suitability and "Know Your Customer". Thank you. MJH

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June 26, 2009

Marcia E. Asquith
Office of the Corporate Secretary
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RE: Comments on Regulatory Notice 09-25: Suitability and "Know Your Customer"

Dear Ms. Asquith:

FOLIOfn Investments, Inc. ("Folio"), a registered self-clearing broker dealer and member of the Financial Industry Regulatory Authority ("FINRA"), submits these comments on FINRA's proposed consolidated rules governing suitability and know-your-customer obligations set forth in Regulatory Notice 09-25 (the "Proposed Rules"). Folio is an online only broker dealer that does not provide advice or recommendations, does not associate any registered sales people with customer accounts, and, although it is authorized to do so, does not currently extend margin credit. Our customer base consists of self-directed individuals (and their common investing vehicles such as trusts), as well as clients of independent, unaffiliated Registered Investment Advisors ("RIAs"). These RIAs use Folio's clearing platform to execute securities trades on behalf of their clients and to custody their clients' investment assets. Folio has been in business since 2000 successfully using this model and operating solely under the predecessor NASD rules.

Folio's comments on FINRA's suitability and know-your-customer rule proposal are set forth below. Section I outlines Folio's general comments on the Proposed Rules. Section II sets forth Folio's comments regarding specific provisions of the Proposed Rules.

I. General Concerns Regarding the Proposed Rules

A. Suitability Requirements and Online Accounts

Folio strongly recommends that FINRA address the Proposed Rules' failure to acknowledge and take into consideration the online brokerage business by incorporating into the Proposed Rules its prior guidance on online suitability.

Since the early 1990s the online self-directed brokerage business has been built as a model in which brokers dealers do not know their customers. Under this

model, investors are given direct access to their accounts online, which allows them to trade and manage their assets without a broker dealer's personnel as intermediary. This business model, the benefits of which FINRA has previously acknowledged in Notice to Members ("NTM") 01-23, is not directly mentioned in the Proposed Rules, but should be re-validated. Millions of investors have enjoyed the ever-expanding access they have to information and markets unencumbered by salespeople or recommendations. The firms that offer an online channel have had no problem determining customer identity, assigning credit limits, and providing tools and content that is not in the nature of a recommendation, in an environment where the broker dealer captures minimal consumer information. Rule 17a-3 adopted by the Securities and Exchange Commission ("SEC") under the Securities and Exchange Act of 1934, as amended ("Exchange Act") already recognizes this fact by not requiring the collection of information for customer accounts where a broker dealer has not made a suitability determination for the account during the prior 36 months. Instead, in this situation, Rule 17a-3 requires only a record of the name and address of the beneficial owner of an account. While the Proposed Rules addressing suitability are triggered by recommendations, given that there is no clear definition of what constitutes a recommendation, we feel it is important that FINRA re-validate that, in the online self-directed arena, neither broker dealers nor their registered associated persons need to know their customer, in a suitability sense, unless they make a direct, tailored recommendation.

To address this issue, FINRA should incorporate into the Proposed Rules its prior guidance regarding online suitability. Specifically, NTM 01-23 issued in April 2001 (Online Suitability) contains dialogue and examples that are very relevant to and should be included in the Proposed Rules. NTM-01-23 provides a good discussion of the context under which presentations become a recommendation and concrete examples of what might be and what would likely not be a "recommendation" in the context of electronic communications. This material is directly relevant not only to online activity but to human interaction as well. We strongly recommend that this material be incorporated into any rule that is finally published and should be broadened to cover human interaction between a broker dealer's registered personnel and its customers.

B. The Use of Investment Analysis Tools

Similar to the above, Folio strongly recommends that FINRA include in the Proposed Rules provisions that address the applicability of a broker dealer's suitability obligations to its use of investment analysis tools. Online self-directed investors self select what information they want and decide how to use it with little, if any, input from their brokerage firms. Firms may provide tools and content for use by consumers, but those tools do not generally "recommend" securities transactions or strategies tailored to specific individuals at an identified investment moment in time. The tools do help consumers winnow down the vast

universe of investment possibilities to smaller groupings of investment choices, which an investor can research or further “watch” until such time that the investor decides to make (or end) an investment. FINRA has previously addressed, in NTM 01-23 and IM-2210-6 (Requirements for the Use of Investment Analysis Tools), the use of these tools, including how the suitability rules apply to their use. FINRA carefully crafted NTM 01-23 and IM-2210-6 to acknowledge the unique and still developing online delivery of financial services, including the use of investment analysis tools, and online brokerage firms have tailored their businesses to comply with this guidance. The Proposed Rules should, therefore, be revised to include provisions that address the applicability of the Proposed Rules to the use of investment analysis tools. These provisions should be consistent with NTM 01-23 and IM-2210-6

C. Focus of the Suitability Rule

We strongly recommend that any rules adopted specify their purpose and stick to addressing that purpose. For example, the predecessor NYSE know-your-customer rule was designed to protect broker dealers from investors with bad credit. The predecessor NASD suitability rule was designed to protect customers from recommendations that were not suitable for them. The Proposed Rules go beyond these purposes and should be revised to remain consistent with the protection of customers against unsuitable recommendations.

In the context of knowing your customer’s identity and making a credit determination, the only data needed is an investor’s name, address, and tax identification number. The commercial databases firms use today can provide a full identification and a very robust credit profile on any adult U.S. citizen using only those three criteria. None of the new data elements suggested in the Proposed Rules such as “customer financial profile”, “investment objectives or policy”, “investment experience”, “investment time horizon”, “liquidity needs”, or “risk tolerance” are of any value to an identity or credit analysis. While firms may decide to acquire other financial information from a customer for credit determination purposes, the specific information called for should be left to each firm’s judgment. Because basic account information collection is already required by FINRA Rule 3110, neither the concept of identification nor the concept of credit qualification should be addressed in the Proposed Rules. Between Rule 3110 and the anti-money laundering and anti-terrorism obligations firms are required to meet, sufficient regulatory attention is already paid to these two concepts and should not be repeated in this rule.

In the context of suitability, if the Proposed Rules regarding suitability remain focused on recommended trades or strategies, the specific data elements that broker dealers collect to meet the underlying purpose of the rule, making sure that a recommendation is suitable for a particular customer, should be left to the firms as detailed below. The information required by SEC Rule 17a-3 will drive

the minimum data collection level. Firms will adopt different approaches to data capture and analysis based on what they are offering and their unique approach to customer profiling. This will allow for differences in the marketplace, but those differences will permit the healthy development of approaches and methods of profiling existing and potential customers.

D. The Scope of the Suitability and Know-Your-Customer Rules

Folio believes that the Proposed Rules should not be, and is strongly opposed to them becoming, the vehicle that drives conversion of the commission broker dealer business model to a model that requires a full financial plan for a customer or prospective customer before a broker dealer may make a recommendation. As proposed, the Proposed Rules would expand the scope of the suitability and know-your-customer rules to the point that it would have this affect on broker dealers' businesses. While different business models, typically financial planning, portfolio management, and/or investment advisory services, do exist and generally require the collection and utilization of more information, a specific list of data points is not required by, and should not now be pushed upon, general brokerage firms or on online self-directed firms simply because they make recommendations that are incidental to their business. Adoption of the Proposed Rules as proposed, would effectively force upon general brokerage and online brokerage firms a business model that they did not select.

Furthermore, firm's wishing to provide an investment advisory service, portfolio management service, or financial planning service are required to register with the SEC as investment advisers. As a result, these firms will collect the information they believe is necessary to provide services to their customers in a manner that fulfills their fiduciary obligations under SEC and common law rules. To the extent that the SEC believes that it would be appropriate to specify the customer information that such firms collect, the SEC is the appropriate regulator to do so.

E. FINRA Should Eliminate Supplementary Materials from Rule Proposals

Folio recommends FINRA eliminate supplementary material from the Proposed Rules specifically and from all rules in general. If FINRA has identified material that is important to a rule's application, it should be included in the text of the rule. Consistent with this recommendation, FINRA should rewrite the Proposed Rules such that all of the relevant content is included in the base rule, not in supplementary material labeled .01, .02 and .03. While this is perhaps a cosmetic comment it would be helpful to adopt a process that puts all rule text within the actual rule.

F. FINRA Should Not Expand Suitability Obligations to Situations Not Involving Securities

FINRA included in NTM 09-25 a request for comment regarding whether it should propose expanding suitability obligations to all recommendations of investment products, services, and strategies made in connection with a firm's business, regardless of whether the recommendations involve securities. Folio strongly opposes expansion of FINRA's suitability rules in this manner. FINRA does not have the statutory mandate to expand its oversight to include activities that do not involve securities and should not attempt to do so. Absent congressional action to expand FINRA's authority beyond the securities markets, this should not be a goal of FINRA.

II. Comments Regarding Specific Provisions of the Proposed Rules

A. Elimination of Specific Criteria from the Proposed Rule

1. Policy Reasons

Folio believes that, as a matter of policy, FINRA should eliminate as many "specific" dictates in its rules as possible. The tremendous rate of change sweeping the industry because of the internet and customer access to information makes specific dictates obsolete quickly, but locks in the industry to fixed practices when they exist.

In their current form, the Proposed Rules regarding suitability set forth several specific pieces of information that a broker dealer must collect to make a suitability determination (e.g., investment experience, investment time horizon). Locking in the information that broker dealers must collect may ultimately require broker-dealers to adopt data collection practices that are ultimately unnecessary and/or inefficient. Furthermore, collecting the information specified would require broker dealers to engage in full-blown financial planning in order to make a recommendation (investment time horizon, other investments, financial situation and needs, tax status, and investment experience), which, as stated above, is not an appropriate objective of the Proposed Rules. Outlining the exact information that must be gathered in any customer profiling scenario is, therefore, bad policy. As a result, we strongly recommend that all language specifying what information ought to be collected be removed from the Proposed Rules.

2. Duplicative Requirements and Flexibility

In addition to the policy implications, FINRA should eliminate from the Proposed Rules the requirement to collect specific data elements, because it is duplicative

of existing requirements and is not flexible enough to permit broker dealers to adjust their practices to fit their specific business model.

Many of the data elements set forth in the Proposed Rules are already adequately covered by information broker dealers must collect under existing SEC and FINRA rules. For example, in the context of identity, FINRA Rule 3110 requires a broker dealer to collect a customer's name, address, age, and, for non-natural person accounts, the name of the authorized person for the account. Rule 3110 also requires broker dealers to use reasonable efforts to collect a customer's tax ID, occupation, and the name and address of the customer's employer, as well as determine whether the customer is an associated person of another member. NYSE Rule 405 more broadly requires broker dealers to use due diligence to learn the essential facts relative to every customer, cash or margin account accepted, and anyone holding a power of attorney over any account. Under SEC Rule 17a-3, if a firm has made a recommendation within the last 36 months with respect to an account, a broker dealer is required to collect for that account the customer's name, tax ID, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and investment objectives. For accounts for which a broker dealer has not made a recommendation in the past 36 months, Rule 17a-3 a broker dealer to collect only the name and address of the beneficial owner of the account.

Furthermore, the requirement to collect specific data elements set forth in the Proposed Rules are not flexible enough to take into account the various business models utilized by broker dealers. For example, broker dealers offering basic brokerage accounts and online accounts offer investment solutions, sometimes on a recommended basis, for a particular amount of investable assets. These services, especially in the self-directed context, require a broker dealer to collect a minimal amount of information from the customer. Other brokerage offerings, such as discretionary accounts managed by either registered representatives or RIAs, financial planning services (which can be centered around specific amounts of investable assets or around holistic financial life planning), trust services, and portfolio management are tied to a firm's investment advisory business and provide customers with a wider range of advice and planning. These services require not only the collection of the data elements set forth in the Proposed Rules, but also a large number of other data points, including subjective "needs and wants" information not identified in the proposal. It should, therefore, be left to each firm to determine, based on the services they provide, what, if any, information is needed from a customer and when that data is needed in the context of making a recommendation.

In light of the above, FINRA should adopt a rule that states that broker dealers should collect sufficient data and perform the analysis that it, in its professional

judgment, deems reasonably necessary to provide the services it offers and advertises to consumers. To that end, Folio strongly recommends that FINRA modify the language in proposed Rule 2111(a) to read as follows:

(a) A member or an associated person must 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 facts known by the member or associated person or disclosed by the customer in response to the member's or associated person's reasonable efforts to obtain information which in the professional judgment of the member or associated person is reasonably appropriate under the circumstances. The neglect, refusal, or inability of a customer or account owner to disclose information shall excuse the member or associated person from obtaining the information.

The above language borrows from SEC Rule 17a-3 and incorporates language from proposed Rule 2111 without specifying the specific information that a broker dealer must collect. Adopting this language will ensure that the Proposed Rules do not duplicate data gathering requirements set forth in existing SEC and FINRA rules. In addition, because it is general in nature, it will allow firms that do not conduct suitability determinations the flexibility to decide what data collection is most appropriate for their business model and to meet their obligations under anti-money laundering and anti-terrorism laws.

In the event FINRA determines that specifying data elements broker dealers must collect is appropriate, the Proposed Rules should not mandate the collection of any information not specified in SEC Rule 17a-3. The financial profile data elements listed in the Proposed Rules that are not also set out in SEC Rule 17a-3 are not universally accepted as essential to performing a suitability determination. A simple survey of the most commonly used software for financial profiling of customers shows a wide range of data elements not included in the Proposed Rules. Picking only some of the most common financial profiling questions but not all, as a mandate, is bad policy. The mix of data elements suggested appears to be a collection of the SEC required data elements, the currently specified financial status questions, financial goal setting questions, risk tolerance questions, and credit determination questions. Because most broker dealers do not provide financial planning, portfolio management, and brokerage as part of their basic brokerage account offering, the approach taken by the Proposed Rules is excessive.

In addition, if FINRA determines that specifying data elements broker dealers must collect is appropriate, it should move the concept that a broker have a "reasonable expectation that the customer has the financial ability to meet such a commitment", because this is a credit concept that has little or nothing to do

with suitability. While the credit decision process at a firm is of regulatory import, it should be discussed in the general financial rules area and not as part of a suitability rule.

B. Use of Collected Data

If FINRA determines that it is appropriate to specify the information that broker dealers must collect when making a suitability determination, FINRA should also include in the Proposed Rules provisions regarding how it expects broker dealers to use such information. Requesting data from consumers builds an expectation that the data will be used for a specific purpose. If FINRA is going to mandate what data broker dealers must collect, it should also publish the exact tests that broker dealers should run against the data and what those results should dictate. If FINRA knows what information all broker dealers must collect regardless of their business model, it must also know what analysis must be done with that information and what results dictate that a broker dealer not make a recommendation. If FINRA cannot specify how broker dealers should use the information, it is disingenuous and misleading to the public for FINRA to specify specific data elements broker dealers must collect.

C. Definitions of "Investment Strategy" and "Recommended Transaction"

Because the terms act as a trigger for a broker dealer's suitability obligations, the Proposed Rules should define "investment strategy" and "recommended transaction". Leaving these terms undefined will create uncertainty and may subject certain broker dealers to suitability obligations in situations in which they have made no recommendation. For example, Folio espouses to all that investment in a diversified portfolio of equity securities is a good thing for any investor. We recommend that approach, not to any specific investor, but to everyone. In Folio's view, because every transaction executed on our on-line platform is initiated independently by a self directed investor, Folio does not make any recommendations to its customers. Yet we espouse an "investment strategy" as that concept is commonly understood. The fact is that much of the material in the financial world is similarly either descriptive of products and services or educational in the context of describing approaches that firm's believe in or find credible. That alone should not, as a matter of policy, trigger a mandatory financial profiling of a client. A clear triggering event should be required before the rule is invoked.

Furthermore, not defining "recommended transaction" will make it difficult for broker dealers to distinguish recommended transactions from discussed and/or reviewed transactions. It is often the case in the retail brokerage space that customers who are "validators" (as distinguished from "delegators" who seek to

be told what to do) have wide ranging conversations with a broker about what might be a good investment. The current industry compliance rule of thumb matches customer action within a measured period of time after information is provided to a customer as a test of whether any resulting transaction was "recommended". It would be helpful for the rule to acknowledge that a discussed transaction might not be a "recommended" one requiring profiling and analysis. Including a definition that adds more certainty to this area would not be extremely difficult in light of that fact that FINRA has already taken steps to address this issue. The discussion in NTM 01-23 provides a good foundation upon which FINRA can base the definition.

D. Information Known by the Member or its Associated Persons

Finally, Folio strongly recommends that FINRA limit the information "know by the member" that must be factored into a broker dealer's information analysis. The text of NTM 09-25 states, in part, that "... the information that must be analyzed in determining whether a recommendation is suitable would include not only information disclosed by the customer in response to the member firm's or associated person's reasonable efforts to obtain it, **but also information about the customer that is 'known by the member or associated person'**" (emphasis added). This concept should not be left as open ended as it has been proposed. A clear statement that FINRA does not require firms to "know" and apply information from other accounts at the firm where the customer is a beneficial owner or any information which could be researched but is not part of the brokerage firm's ordinary business process should be included in the Proposed Rules. Looking at someone's rants on their facebook pages is not something that firm's should be required to do.

III. Conclusion

The suitability rule is an important part of the regulatory infrastructure that supports a retail brokerage business model as distinct from a registered investment adviser business model. It is important to the brokerage industry that investment advisory concepts not be forced upon the basic brokerage model. The value to consumers of having access to brokerage services and recommendations incidental to those services for a reasonable price is enormous. We urge FINRA to reconsider how best to combine and modernize the NASD and NYSE rules in this regard. The Proposed Rules should be significantly reworked consistent with the recommendations in this comment letter before it is moved forward for adoption.