FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS
www.financialservices.org

VIA ELECTRONIC MAIL

June 29, 2009

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

RE: FINRA Regulatory Notice 09-25: Suitability and Know-Your-Customer Obligations

Dear Ms. Asquith:

On May 15, 2009, the Financial Industry Regulatory Authority, Inc. (FINRA) published Regulatory Notice 09-25 seeking comment on its proposal to consolidate the existing rules governing suitability and the know-your-customer obligations into new FINRA Rules 2111 and 2090 (Proposed Rule).[1] The Proposed Rule would combine the terms of NASD Rule 2310, addressing suitability obligations, and Incorporated NYSE Rule 405, addressing know-your-customer obligations, into a single rule as part of the Consolidated FINRA Rulebook. In addition, the Proposed Rule would codify various interpretations regarding the scope of the suitability rule, clarify the information to be gathered and considered as part of a suitability analysis, and create an exemption for recommended transactions involving institutional customers, subject to specified conditions.

The Financial Services Institute[2] (FSI) recognizes that combining the rulebooks of the predecessor regulatory authorities represents a significant challenge. As we have in the past, FSI commends FINRA for recognizing in the rulebook consolidation process an opportunity to develop a new organizational framework for the rules, consider new approaches to regulatory concerns, and delete obsolete rules. With so many changes in the structure and substance of the rulebook being considered, we believe industry input is more important than ever. We, therefore, praise FINRA for seeking industry comment on the Rule Proposals prior to submitting them to the SEC.

Nevertheless, FSI is concerned about the potential unintended consequences of the Proposed Rule. First, we believe the Proposed Rule has been offered for consideration prematurely. Second, we are concerned that the Proposed Rule expands the suitability obligation by introducing undefined criteria and portfolio level concerns. Third, the Proposed Rule's requirement that recommendations be based on information about the client known to the broker-dealer or associated person is both unworkable and unreasonable. Finally, we object to FINRA's suggestion that the suitability rule be applied to recommendations of non-securities investment products, services, and strategies. Our specific detailed comments are offered in this letter.

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[1] See FINRA Regulatory Notice 09-25 at http://www.finra.org/Industry/Regulation/Notices/2009/P118709.

[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 119 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 12,500 Financial Advisor members.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 98,000 independent financial advisors – or approximately 42.3% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments on the Proposed Rule

As mentioned above, FSI has significant concerns with the Proposed Rule. We discuss these comments in detail below:

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[3] Cerulli Associates Quantitative Update: Advisor Metrics 2007, Exhibit 2.04. Please note that this figure represents a subset of independent contractor financial advisors. In fact, more than 138,000 financial advisors are affiliated with FSI member firms. Cerulli Associates categorizes the majority of these additional advisors as part of the bank or insurance channel.

[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

- Proposed Rule is Being Considered Prematurely – FINRA is currently engaged in the process of integrating the existing NASD and NYSE rules into a consolidated rulebook. This is an important project with wide reaching implications. It is, however, only one small part of the current debate surrounding the financial services regulatory structure. An important issue in this debate is the standard of care owed by a financial advisor to a client.[5] The resolution of this debate has the potential to make the Proposed Rule a moot point or, at the very least, alter its implications substantially. As a result, we urge FINRA to delay the Proposed Rule while we await clarity on the broader standard of care issue. Such an approach will reduce the cost and confusion inherent in making two significant and fundamental changes to this foundational principle within a relatively short timeframe.

- Proposed Rule Inappropriately Expands Suitability to Include Poorly Defined Criteria and Portfolio Level Concerns – The Proposed Rule expands the information that must be analyzed in determining whether a recommendation is suitable for a client to include the following additional criteria:

  - Client's age,
  - Other investments,
  - Investment experience,
  - Investment time horizon,
  - Liquidity needs, and
  - Risk tolerance.

  While the client's age and other investments are specific and easily obtained data points, the other new suitability criteria are less clear or quantifiable. While independent financial advisors are accustomed to gathering detailed information from their clients and making suitable securities transaction recommendations based upon this information, introducing new undefined criteria unreasonably expands the opportunities for plaintiff's attorneys and regulators to second-guess a financial advisor's recommendations with the benefit of hindsight. We urge FINRA to plainly define the new terminology so that broker-dealers and financial advisors can fully understand their responsibilities and reasonably defend themselves in any adversarial process.

  In addition, we believe that a client's investment time horizon, liquidity needs, and risk tolerance are important considerations that must be judged at the portfolio level. However, the Proposed Rule would appear to require each securities transaction to be suitable based upon these additional criteria. We believe this would have unfortunate unintended consequences for investors who may have several competing investment objectives that are best met by a fully diversified portfolio made up of securities of varying degrees of liquidity, risk, and anticipated holding periods. As a result, we ask FINRA to clarify the Proposed Rule to state clearly that such suitability criteria are to be evaluated as part of the customer's entire investment portfolio – not on a transaction basis.

- Proposed Rule Inappropriately Expands the Suitability Review to Information Known By the Broker-Dealer – Independent financial advisors operate their own small businesses in communities throughout the country. They can compete with other financial advisors

[5] See page 71 of "Financial Regulatory Reform: A New Foundation: Building Financial Supervision and Regulation" at http://financialstability.gov/docs/regs/FinalReport_web.pdf.

who are registered with the same broker-dealer or move their business from one firm to another. As a result, it is quite possible for an independent broker-dealer's records to include information about a client that was collected by one financial advisor, but unknown to the client's current financial advisor. The Proposed Rule would appear to require independent broker-dealers to engage in a search through all of their internal client databases, files, and documentation along with the records of their affiliated independent financial advisors to determine if there is other relevant suitability information "known by" the firm. Only then would the firm be certain it was meeting its obligations. This is simply unworkable and unlikely to result in a significant improvement in investor protection. We, therefore, urge FINRA to strike this requirement from the Proposed Rule.

- Proposed Rule Should Clarify the "Know Your Customer" Obligation – The Proposed Rule's "Know Your Customer Obligation" fails to define key terms and is, therefore, too vague to provide broker-dealers and financial advisors the guidance necessary to adopt policies and procedures designed to insure compliance. Proposed Rule 2090 requires members to "use due diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[6] We believe the clarity of this section would be greatly enhanced by defining the term "maintenance" so that its scope is limited to the broker-dealer's existing obligations under Securities Exchange Act Rule 17a-3.[7]

  In addition, we note that the proposed Supplementary Material states that the facts essential to knowing the customer include the customer's "financial profile and investment objectives or policy."[8] The term "financial profile" is not defined. As a result, broker-dealers and financial advisors are left to guess if FINRA intends to refer to the criteria specified in the suitability rule or something different. We urge FINRA to amend this language to refer specifically to the suitability criteria of Proposed Rule 2111 thereby eliminating any opportunity for confusion.

- FSI Opposes Expanding Suitability Requirements to Non-Security Investment Products or Services – Regulatory Notice 09-25 requests comment on whether FINRA "should propose expanding the suitability obligation to all recommendations of investment products, services, and strategies made in connection with a firm's business, regardless of whether the recommendations involve securities."[9] The sale of insurance products, investment advisory services, and other products and services are already closely regulated by state and federal authorities. FINRA's suggestion that its suitability rule should apply to these activities would result in redundant, conflicting, and contradictory regulatory requirements that do not advance the goal of investor protection. As a result, we vigorously oppose FINRA's suggestion that it expand the suitability obligations to these additional products, services, and strategies.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to enhance investor protection.

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[6] See page 9 of FINRA Regulatory Notice 09-25.
[7] 17 C.F.R. §240.17a-3.
[8] See page 9 of FINRA Regulatory Notice 09-25.
[9] See page 3 of FINRA Regulatory Notice 09-25.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO