SIFMA®
Securities Industry and
Financial Markets Association

June 29, 2009

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1500

Re: FINRA Regulatory Notice 09-25 – Proposed Amendments to the Suitability and Know Your Customer Rules

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the above-referenced Regulatory Notice, in which FINRA proposes to adopt new modified rules and related Supplementary Material governing suitability and know-your-customer obligations in the Consolidated FINRA Rulebook.

Suitability and know-your-customer obligations are among the bedrock principles underlying investor protection and fair dealing with customers. SIFMA, therefore, commends FINRA for its efforts to streamline and enhance rules within the single rulebook that support these two obligations. We believe, however, that certain provisions of the rule require reconsideration. Specifically, our comments will focus on four main points, wherein we request that FINRA revise the rule proposal as follows:

- *Institutional Client Suitability*. Eliminate the newly proposed institutional client affirmative opt-out requirement from the institutional customer exemption and instead retain only the independent judgment and evaluation requirements, which are reflected currently in NASD IM 2310-3.

- *Know Your Customer Requirements*. Revise proposed Rule 2090 to more sharply focus on information necessary to open an account and remove references to information more appropriate for a suitability analysis.

- *Enumerated Suitability Elements.* Clarify that member firms, when making a recommendation, need not obtain information related to each of the new enumerated

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[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

suitability factors in all instances, but can take into account, as appropriate, the relevance of each factor depending on the specific facts and circumstances of the recommendation.

- *Extension of Suitability Obligations to Non-Securities Investment Products.* Decline to extend suitability obligations beyond securities investment products since other regulators already have jurisdiction and in some cases specific rules for such suitability obligations.

In addition, and as set forth in Section V of the letter, SIFMA provides further comments and recommendations for technical clarifications to the proposal.

I. Exemption for Institutional Customers From Customer-Specific Suitability Obligations

In the proposal, FINRA seeks to revise the definition of "institutional customer" in the suitability rule to increase the threshold to $50 million in assets from the current $10 million invested in securities and/or assets under management. SIFMA supports this new definition and commends FINRA for harmonizing the definition of "institutional customer" in the suitability rule with the definition of "institutional account" in NASD Rule 3110(c)(4). Consistent standards within the FINRA rulebook – and indeed across regulators – produces more efficient, effective and clear regulation that is beneficial to investors, regulators and market participants alike.

A. The Affirmative Indication Requirement is Impractical and Will Render the Institutional Customer Exemption Ineffective

SIFMA has several concerns with the affirmative indication requirement of the proposed institutional customer exemption. As proposed, the exemption provides that a member firm satisfies its customer-specific suitability obligations to an institutional customer if:

a. The customer *affirmatively indicates* that it is willing to forego the protection of the customer-specific obligation of the suitability rule; *and*

b. The member firm or associated person has a reasonable basis to believe that the institutional customer is (i) capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (ii) exercising independent judgment in evaluating the member's or associated person's recommendations.

The two requirements articulated in subsection (b) reflect the current standard for institutional suitability under NASD IM 2310-3 in the FINRA Transitional Rulebook. The proposed affirmative indication requirement is a new condition that firms would have to satisfy in order to avail themselves of the exemption. FINRA's proposal does not provide a rationale for this additional requirement, and we are unaware of any specific regulatory concerns or issues with the current institutional exemption, as set forth in IM 2310-3.

SIFMA believes that this aspect of the proposed rule is highly problematic for several reasons. First, we believe an affirmative opt-out of customer-specific suitability is unnecessary in light of the other two currently existing conditions, especially when we consider the proposed new definition of institutional customer. In our view, institutional clients capable of evaluating risks independently and exercising independent judgment in assessing a member firm's recommendations do not need customer-specific suitability protections. Indeed, many institutional investors already are obligated to make their own suitability determinations pursuant to other applicable regulatory schemes. For example investment advisors have fiduciary obligations to their clients and typically accept responsibility for determining the suitability of investments made on behalf of their managed accounts.[2]

Moreover, because institutional clients are highly unlikely to affirmatively forego suitability protections for commercial reasons, this new requirement will have the practical effect of negating both the proposed and existing exemption. Thus, contrary to FINRA's stated objective of creating a "clear exemption" for recommendations to institutional clients, the net effect of this requirement will be to subject recommendations to institutional clients to the full range of enumerated suitability elements -- the vast majority of which are ill-suited for non-retail clients.[3] In cases where a firm is unable to obtain the affirmative opt-out from the institution, the determination of "financial ability," as well as the other suitability elements (e.g., liquidity needs, investment time horizon and risk tolerance) make little sense.[4] Similarly, it will be virtually impossible for an associated person to determine the institutional customer's "other investments" and utilize that information in the suitability review. Institutional customers typically are serviced by many broker-dealers and generally are unwilling to disclose information about other investments or trading activities through other firms.

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[2] The following language is from a typical letter an investment adviser provides to broker-dealers in lieu of normal account opening documentation for a DVP account:

> We are a registered investment adviser and act as such for a number of clients under an agreement or power of attorney to invest on their behalf. We are fully aware of the financial position and the investment objectives and investment limitations of these clients. We are capable of independently evaluating the investment risk of the orders we place with BROKER-DEALER and are exercising independent investment decisions without reliance on BROKER-DEALER's recommendations or advice, if any. In lieu of furnishing BROKER-DEALER with specific evidence of our authority and other information in connection with each account in which we give an order, we agree (without limiting our obligations to BROKER-DEALER) to indemnify and hold BROKER-DEALER harmless in the event that any person or entity should make claim against BROKER-DEALER that BROKER-DEALER's execution of any order on the basis of our instruction was without authority or was not suitable for the account. We represent that we have all necessary authorizations to enter into this Agreement.

[3] Indeed, we question the appropriateness of limiting the exemption to customer-specific suitability. If the institution satisfies the standards of independent valuation and judgment, the institution should be exempt from all aspects of the suitability rule.

[4] For example, member firms typically conduct standard credit department analysis and implement related credit limits whenever a transaction creates credit risk to the firm.

In light of the forgoing, SIFMA respectfully requests that FINRA remove the affirmative indication requirement in any proposed rule change that it files with the SEC and return to the current standard. We also note that the proposed affirmative indication requirement would create a regulatory imbalance with corresponding requirements in major non-U.S. jurisdictions, which do not have a similar affirmative requirement.[5]

B. Application of Suitability Standards to Institutions

SIFMA also respectfully requests that FINRA consider bifurcating the rule proposal to clearly delineate the suitability obligations of retail and institutional customers, recognizing the critical differences between the two types of clients. For example, the basic provisions of proposed Rule 2111(a) of the rule make sense in connection with the retail customers but do not with respect to institutions. Further, the related suitability Supplementary Material is, for the most part, inapposite with respect to institutions. Restructuring the proposed suitability rule to separately deal with institutional clients, we believe, will provide additional clarity as to member firms' specific obligations to their retail and institutional customers.[6]

II. Know Your Customer Obligations

SIFMA is concerned that FINRA's proposed "know your customer" requirements unnecessarily overlap with the proposed suitability requirements. Proposed Rule 2090 and its Supplementary Material .02 would require firms to obtain "essential facts" about all customers upon account opening, including information relating to the *"customer's financial profile and investment objectives or policy,"* and through the life of the client relationship. As explained in FINRA's Regulatory Notice:

> Firms would be required to use due diligence, in regard to the opening and maintenance of every account, to know the essential facts concerning every customer (including the customer's *financial profile and investment objectives or policy*). This information may be used to aid the firm in all aspects of the customer/broker relationship, including, among other things, determining whether to approve the account, where to assign the account, *whether to extend margin* (and the extent thereof) and whether the customer has the *financial ability to pay* for transactions. The obligation arises at the

[5] *See, e.g.*, Financial Services Authority Conduct of Business Sourcebook Rule 9.2.8 (providing that a firm may assume that a "professional client," in relation to the products, transactions and services for which the professional client is so classified, may assume that the client is able to financially bear any risk consistent with the client's investment objectives); *see also* Article 35(2) of the MiFID Implementing Directive.

[6] Given market practice and the manner in which member firms often interact with institutional customers, it also would be helpful for FINRA to make a formal written distinction between a (i) a customer-specific recommendation; and (ii) information about the availability of securities for purchase or sales, trading ideas, strategies, market color and commentary ("commentary') and research. Specifically, information that certain securities are available for purchase or sale such as "axe sheets" and similar "runs," indications of interest, working a block size customer order to find the other side of that trade should not be considered recommendations. Similarly, member firm commentary to institutional clients that discusses strategies, market color and trends, or trade ideas should also not be considered a recommendation.

> beginning of the customer/broker relationship and does not depend on whether a recommendation has been made (emphasis added).

While SIFMA fully supports "know your customer" obligations, we believe that the rule proposal blends "know your customer" concepts with suitability requirements. This blending may stem from the fact that in proposed Rule 2090, FINRA incorporated many of the elements currently contained within NYSE Rule 405 -- a rule that historically served the dual purposes of both account opening and suitability requirements because NYSE did not have an independent suitability rule.[7] Certainly, the FINRA Consolidated Rulebook should continue to have a stand-alone suitability rule as well as other rules related to approval and supervision of accounts. As such, we believe the proposed know-your-customer rule should be limited in scope to essential facts necessary to open the account – i.e., the identity of each account owner, their address, the legal authorization of each person having investment authority with respect to the account, the source of funding for the account and the credit status of the account owners. Information relative to "whether to extend margin," "investment objective," and "financial profile" may be necessary for a suitability analysis, and efficient to obtain at account opening, but it is not necessarily required for certain institutional accounts and self-directed execution-only accounts.[8]

Moreover, the collection of suitability information under proposed Rule 2090 creates potential risk issues where the client is self-directed or has trading directed by an authorized third party fiduciary. The possession of this data could create uncertainty as to a member's responsibilities where a customer, or a third party power of attorney, engages in unsolicited trading activity that is inconsistent with the investment objective and financial profile information collected under the proposed rule.

SIFMA therefore recommends that FINRA remove proposed Supplementary Material .02 to Rule 2090 in its entirety from the rule proposal, and instead permit each firm to interpret and apply the "essential facts" standard to their particular business model, recognizing that it is the nature of the relationship between the firm and customer that dictates those facts. This approach retains the flexibility currently embedded within NYSE Rule 405 and at the same time avoids duplication of other existing regulatory obligations governing approval and supervision of accounts, such as Rule 3110 (Books and Records), 3011 (Anti-Money Laundering Compliance Program), Customer Identification Program requirements, and the SEC's books and records rules.

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[7] Rule 405 articulates a general standard that obligates firms to "use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."

[8] The undefined term "*financial profile*" is particularly confusing in the context of know-your-customer obligations when read in conjunction with Rule 2111 related Supplementary Material .03. There, FINRA uses the similar term "*customer's profile*" in connection with customer specific suitability obligations and cross-references expanded suitability elements delineated in Rule 2111(a). Consequently, there is great uncertainty as to whether Rule 2090 is intended to suggest that broker-dealers must obtain the full range of information enumerated in proposed Rule 2111 for all accounts at the inception of the relationship, regardless of the nature of the account or transactions executed therein.

III. Proposed Suitability Data Elements

Currently, NASD Rule 2310 requires broker-dealers and associated persons to obtain information about a customer's financial status, tax status and investment objectives. Under proposed Rule 2111(a), FINRA seeks to expand the information to be gathered to include: (1) customer's age, (2) investment experience, (3) investment time horizon, (4) liquidity needs, and (5) risk tolerance.

SIFMA appreciates FINRA's efforts to enhance the suitability rule to more clearly identify the type of information that could be relevant to member firms and their associated persons when making recommendations to clients. We are concerned, however, that absent further clarification, the newly enumerated data elements could create a presumption that a recommendation is suitable only if information relating to each enumerated item is solicited and considered at the time of the recommendation, irrespective of the type of account, client or transaction.

SIFMA believes an overly prescriptive list of requirements -- i.e. "check the box" approach -- could compromise a firm's discretion in developing its own approach and process for making required suitability determinations. Given the wide array of customer needs, account types, and products, we believe it might not be in a customer's best interest, and indeed extremely difficult, to promote *a prescriptive list of* data elements that must be solicited and considered in *all cases* in order to make a suitable recommendation.[9] Based on a facts and circumstances determination, different data elements may or may not have relevance. Ultimately a member firm should be responsible for determining whether it has sufficient information to make a suitable recommendation to meet a customer's needs, and for demonstrating that it had a reasonable basis to make the recommendation.

SIFMA therefore requests that FINRA revise the proposal clarify that member firms, when making a recommendation, need not obtain information related to each of the new enumerated suitability factors in all instances, but can take into account, as appropriate, the relevance of each factor depending on the specific facts and circumstances of the recommendation. This flexibility will also address concerns noted above about a one-size-fits-all approach to building a suitability profile for otherwise sophisticated and experienced clients that do not meet the proposed definition for institutional customer.

IV. Applying Suitability Obligations to Non-Securities Investment Products

SIFMA believes that extending FINRA's suitability rule to recommendations of non-securities investments or strategies raises a multitude of issues that should be carefully considered before FINRA submits any such proposal to the SEC. Of course, SIFMA member firms fully support the fundamental principle that investment products they sell to a customer should be appropriate for the customer. Nevertheless, non-securities investment products and services (including such products as fixed annuities, life settlements, and commodity futures)

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[9] Further, some firms have developed sophisticated qualitative and quantitative methodologies to analyze client suitability factors. Indeed, these proprietary formulas and methods serve to differentiate the quality and effectiveness of a firm's recommendations.

generally are already subject to the jurisdiction and regulatory requirements administered by other regulatory authorities. Additionally, on June 17, 2009, the Department of Treasury proposed significant federal regulatory reforms to enhance customer financial protection that may result in additional customer protection requirements and regulatory oversight for non-securities investment products.[10] Consequently, the extension of suitability obligations to these products would create practical difficulties from a supervisory and compliance perspective due to potentially conflicting or redundant regulatory obligations.[11] SIFMA therefore strongly urges FINRA not to expand its suitability requirements beyond securities products and investment strategies without further analysis and discussion with appropriate stakeholders.

V. Additional Comments

A. Application of Suitability Obligations to Recommended Investment Strategies

SIFMA generally supports FINRA's proposal to extend its suitability rule to recommended investment strategies involving securities, but we request additional guidance concerning the scope of the undefined term "investment strategies involving securities." Additionally, we ask FINRA to clarify that there must be a reasonable nexus between the recommended investment strategy and a securities transaction in furtherance of the recommended strategy to trigger the suitability obligation. Absent this clarification, the proposed rule potentially could be construed to extend suitability obligations to all recommended "strategies," irrespective of whether a transaction culminated in furtherance of the recommendation.

B. All Facts Known to the Firm or Associated Person

The proposed rule would require that a member firm's suitability analysis be based on both information disclosed by the customer in connection with the required data elements and *the facts known to the firm or associated person.* SIFMA believes that introduction of the language "all facts known by the member or associated person" is overbroad, is too subjective a standard, and could unfairly impute general knowledge of the firm to an associated person that he or she might not actually possess. Indeed, as written, the proposal could implicate a host of interpretive ambiguities and conflicting duties of privacy and confidentiality with respect to (i) customer information that is provided to affiliates under separate relationships; (ii) information held by a division or function within the broker-dealer subject to an information barrier; (iii) information publically available or available through vendors; or (iv) information revealed in customer service interaction in a division outside of the one in which the account is being serviced.

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[10] See United States Department of the Treasury issued a white paper, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation" ("Treasury White Paper") proposing numerous regulatory reforms to protect consumers and investors, including a proposal to create a new Consumer Financial Protection Agency with broad jurisdiction to protect consumers of financial products.

[11] We note it is not clear that FINRA has a jurisdictional nexus pursuant to the Exchange Act to regulate non-securities products and services.

A common example is where a customer has multiple business relationships with a firm and has not shared information across the organization due to regulatory or privacy concerns (e.g., Chief Executive Office maintains a private client relationship with a registered representative and CEO's company has retained the member firm's investment bank in connection with sale of business). While the full range of information might be "known by the firm," the CEO's registered representative may have no personal knowledge about the potential sale of the company which could benefit the CEO personally. To attribute "firm knowledge" in this case would be impractical, as well as immensely difficult to administer and monitor from a compliance perspective, particularly for firms where customer relationships can be managed by more than one business or assigned representatives.

SIFMA therefore respectfully requests that FINRA remove this aspect of the proposal from any proposed rule change that is filed with the SEC. Alternatively, FINRA should modify the provision to state that the recommendation must be based on facts "available from customer records to or actually known by the associated person making a recommendation" as a reasonable and constructive alternative.

C. Implementation

To allow for adequate time for implementation and training in connection with the new requirements, SIFMA respectfully requests that any proposed rule change filed with the SEC provide for an extended implementation period. Firms will need a significant amount of time to modify account opening and retention systems, amend attendant forms, and collect the new suitability information for existing clients who are recommended a new securities transaction.

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SIFMA appreciates the opportunity to provide comments on FINRA's proposed new rules suitability and know your customer obligations, and looks forward to continuing the dialogue as FINRA moves forward with this critical rule proposal. We also request the opportunity to meet with FINRA staff to discuss the proposal and our letter before FINRA files any proposed rule change with the Securities and Exchange Commission ("SEC"). If you have any questions or require further information, please contact the undersigned at (212)313-1268.

Sincerely,

Amal Aly
Managing Director and
Associate General Counsel