



NASAA

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**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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July 13, 2009

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 2009-25  
“Suitability” and “Know Your Customer”

Dear Ms. Asquith:

On behalf of the North American Securities Administrators Association (NASAA)<sup>1</sup>, I am submitting this comment letter regarding the Financial Industry Regulatory Authority’s (FINRA) proposed rule consolidation for NASD Rule 2310 and NYSE 405 that would alter the obligations for suitability and “Know Your Customer” standards for broker dealers. NASAA appreciates the opportunity to express its views on this matter of vital importance to our nation’s investors, particularly at this point in history when investor protection should be enhanced and retail investor confidence must be restored.

On March 26, 2009, Richard Ketchum, the Chairman and CEO of FINRA testified before the Committee on Banking, Housing, and Urban Affairs within the United States Senate. In part, he stated the following:

One of the primary issues raised about investor protection differences between the broker-dealer and investment adviser channels is the difference between the fiduciary standard for investment advisers and the rule requirements, including suitability, for broker-dealers. As the process moves forward, this is the kind of issue that should and will be on the table as we all look at how best to reform our regulatory system and strengthen investor protections. In keeping with our view there should be increased consistency in investor protections across financial services, we believe it makes sense to look at the protections provided in various channels and **choose the best** of us.

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<sup>1</sup> NASAA is the association of all state, provincial, and territorial securities regulators in North America. Its membership consists of the securities regulators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. Their core mission is protecting investors from fraud and abuse in the offer and sale of securities. Organized in 1919, NASAA is the oldest international organization devoted to investor protection.

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NASAA encourages FINRA to do just that – to choose the best standards – for all types of investors who hold, invest, and receive advice from investment professionals in a broker-dealer context.<sup>2</sup> Thus, NASAA’s comments to the proposed changes to “Know Your Customer” and suitability standards are aimed at eliminating any consideration for weakening current suitability standards through the consolidation of a FINRA rulebook. We encourage FINRA to strengthen the standards for suitability during its rulebook consolidation.

### **Suitability**

NASAA strongly encourages FINRA not to diminish any investor protections or specificity requirements that currently exist in today’s suitability rules through the process of rulebook consolidation.<sup>3</sup>

To that end, NASAA notes the following:

The Interpretive Materials (IMs) that are included within the current FINRA manual for suitability add specificity to the rule language. Registered persons, compliance personnel, investors, and registered principals read and regularly refer to the FINRA manual. The specific examples and discussions contained within the IMs help those in the industry and those investing in securities understand – in clear, every day ways - how the suitability rule applies to specific transactions and situations.

For example, IM-23102(b) currently consists of five subsections which describe specific conduct deemed to be inconsistent with members’ additional duties imposed on members recommending new financial products and derivative products. More, not less specific guidance in these areas is required given the deleterious securities markets. Eliminating access to common interpretation of the rule seems counterintuitive, and reducing the content of 2310-2 to the simple notion of “fair dealing” with customers is inappropriate.

NASAA applauds FINRA’s notion that it is time to codify existing IMs. We encourage FINRA to do so and to mirror the specifics contained within the IMs and to codify that language. NASAA expresses hesitation for the approach of not codifying such language at this juncture.

### **Suitability with three prongs**

The substantive content of Regulatory Notice 09-25 describes in proposed Rule 2111 Supplementary Material .02, the codification of suitability as a three pronged approach to suitability principles. As written, the interpretation appears to create several new standards: reasonable-basis suitability, customer-specific suitability, and quantitative suitability. The description which follows of what the first prong means is not particularly clear. For example, the material states that reasonable-basis suitability requires the member have a “reasonable basis to believe, based on adequate due diligence, that the recommendation is suitable for at least some investors.” Does the fact that a recommendation may be suitable for “at least some investors”

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<sup>2</sup> NASAA has pledged its support for consideration of a **strong** fiduciary duty standard being implemented across the investment industry. While there is a call for a fiduciary duty – NASAA also supports strong, clear, and best in class suitability standards.

<sup>3</sup> It is possible that a fiduciary standard may be incorporated into broker-dealer rules in the future. However, in the interim, and even if a potent fiduciary standard is ultimately adopted (along the lines of ERISA fiduciary standards were to be accepted), suitability ought not to be diminished in the process.

now figure into the determination of whether a recommendation is suitable for a particular investor?

The material goes on to state:

In general, what constitutes adequate due diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy.

Due to its broad and generalized nature, it is hard to say how such a description will assist members of the public. Further, a member's familiarity with a product should be presumed before a recommendation is made; i.e. it should not be part of the question of "adequate due diligence" that a person has familiarized themselves with their recommendation.

NASAA also questions whether the three pronged approach could lead industry defendants to make an argument in the future that suitability standards are strictly limited to the three prongs only – without room for new prongs or measurements to be added in the future of the rule.

### **Suitability and Institutional Investors**

In order to "choose the best" standards for investor protection, NASAA encourages FINRA to carefully examine the carve backs or exemptions from suitability standards that exist today. It is our suggestion that exemptions be narrowed (or at least maintained) rather than broadened in the arena of suitability.

As proposed, Rule 2111(b) appears to provide a "box check" waiver of the customer-specific obligation of the suitability rule for institutions. This hardly seems appropriate given how, for example, securities such as auction rate securities were marketed and sold to both wealthy individuals and institutions. While 2111(b) does incorporate several aspects of the IM 2310-3, the significant material currently set forth in detail under the heading "Considerations Regarding the Scope of Members' Obligations to Institutional Customers," including the bulleted considerations and discussion of various factors should be carried over in its entirety to the new manual. Otherwise, members are left without the benefit of this significant guidance.

Institutional investors – hard hit during the recession and through the auction rate securities dilemma – need the best investor protection standards along side of main street investors.

### **"Know Your Customer" / Due Diligence**

In addition to removal of the IM language of the current rule, NASAA questions the need for removing a specific portion of NYSE Rule 405 in the proposed new rule. The current language reads, in pertinent part:

Rule 405(1) 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.

The proposed language is far less specific. Proposed Rule 2090 states:

Every member shall 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.

Removal of the language from the current rule that states:

[E]very order ... accepted or carried by such organization ... [.]

could be construed to eliminate the requirement that due diligence is being eliminated on a transactional basis. Moreover, the newly proposed rule also could be construed to mean that the focus of “due diligence” has shifted away from knowing the product and solely focused on “Knowing the Customer.” The removal of this language would appear to lower the standards for member firms for compliance with the rule.

While NASAA believes that FINRA may be capturing product due diligence in the term “reasonable basis suitability” in proposed Rule 2090, the wording in 2090 is weaker than the current language of Rule 405. Specifically, 2090 states:

[F]irms must have a reasonable basis to believe, based on **adequate due diligence**, that a recommendation is suitable at least for some investors.

The direct language of 405 – that “every order” must contain due diligence – rather than be suitable at least for some investors based on adequate due diligence – is more clear and preferable over the new language.

Moreover, NASAA suggests that it would be beneficial to include the language that FINRA provides in Regulatory Notice 09-25, prior to the proposed rule language, in the actual proposed rule. FINRA states within the Regulatory Notice that, “The [Know Your Customer] obligation arises at the beginning of the customer/broker relationship and does not depend on whether a recommendation has been made.”

NASAA suggests that this clear language be captured within the actual proposed Rule 2090.

### **Closing Comments**

Finally, NASAA notes that FINRA has sought comment as to whether “suitability obligations [ought to expand] to all recommendations of investment products, services and strategies made in connection with a firm’s business, regardless of whether the recommendations involves securities.”

In order to be make suitable investment recommendations – NASAA believes that general knowledge of and general comparison to non-securities products is implicit for a registered person to make suitable investment recommendations. A registered securities professional needs to be generally apprised of the financial marketplace as a whole in order to be positioned to make suitable recommendations and to fulfill the current obligations of suitability standards.

Moreover, NASAA also believes that consideration of cost to the customer of a securities product is certainly a part of a suitability analysis for an investment recommendation.

The proposed consolidation of FINRA Rule 2310 and NYSE Rule 405 purports that there are no substantive changes in the standards or obligations imposed upon members in the areas of suitability and knowing the customer. Accordingly, NASAA recommends against eliminating the considerable body of interpretive material for each rule (particularly for Rule 2310). Elimination of the IMs serves no useful purpose and fosters a lack of clarity.

NASAA agrees with the statement made by Chairman Ketchum before Congress in March 2009 – that “**the best**” standards should apply to investor protection. Accordingly, NASAA believes that a **strong** fiduciary duty standard coupled with the **strong** suitability language would enhance investor protection and would help to restore more confidence in today’s marketplace. Consideration of fiduciary duty with simultaneous consideration of any weakening to suitability standards would only be a bait and switch for the American public.

Please do not hesitate to contact the undersigned regarding this matter.

Sincerely,

/S/

Rex A. Staples  
General Counsel  
North American Securities Administrators Association