Significant Rule Changes Materially Affect FINRA Members

In January 2011, FINRA announced SEC approval of FINRA Rules 2090 (*Know Your Customer*) and Rule 2111 (*Suitability*) in its Regulatory Notice 11-02. Both Rules become effective on October 7, 2011. These new rules are critically important for all broker dealers who conduct business with customers, both retail and institutional. It is important to review the rules and make applicable changes to all compliance and written supervisory policies and procedures in order to fully reflect these important regulatory changes.

RULE 2090

Rule 2090, *Know Your Customer,* requires FINRA members to use reasonable diligence in regard to the opening and maintenance of every customer account in order to know the "essential facts" concerning every customer. The Notice provides guidance on what these essential facts are, but importantly, the "*know your customer*" obligation arise at the beginning of the customer/broker-dealer relationship and does not depend on whether the broker-dealer makes any recommendations. Further, this obligation is ongoing, as the Rule requires the broker-dealer to know its customer not only at account opening, but also throughout the life of the relationship with the customer. While recognizing that SEC Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain customer account information every 36 months for accounts where the broker-dealer is required to make suitability determinations, FINRA cautions that a firm should *"…verify the essential facts about a customer at intervals reasonably calculated to prevent and detect any mishandling of a customer account that might result from the customer's change in circumstances."* No further guidance is provided by FINRA, except to say that the reasonableness of a firm's efforts in this regard will depend on facts and circumstances.

RULE 2111

With regard to new FINRA Rule 2111, it is modeled after former NASD Conduct Rule 2310 (*Suitability*). Like its predecessor, FINRA 2111 continues to use a broker's recommendation as the triggering event for application of the Rule, while applying a facts and circumstances approach to determining what constitutes a recommendation. Rule 2111 requires that a firm and its associated persons "*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 information obtained about the customer's investment profile.*" However, the determination of whether a recommendation has been made is objective rather than subjective, which puts the onus on the firm to demonstrate why a recommendation or series of recommendations were suitable.

Furthermore, Rule 2111 explicitly applies to recommended investment strategies involving a security or securities. It is critical for firms to be aware that under this new Rule, FINRA has stated that the term strategy would include a broker's explicit recommendation to hold a security or securities. According to FINRA, it is appropriate to hold firms and associated persons responsible for the recommendation to the customer, regardless of whether the recommendation resulted in a transaction or generated transaction-based compensation. Based on this assertion, it appears that firm's will need to review their supervisory and compliance systems to ensure they can monitor for compliance with this aspect of the rule.

EXPANSION OF REQUIRED INFORMATION

In addition, FINRA has expanded the list of explicit types of information that firms must attempt to gather and analyze as part of its suitability analysis. These additional requirements include age, investment experience, time horizon, liquidity needs, and risk tolerance. Although the Rule provides some flexibility concerning the type of information that firms must seek to obtain and analyze, FINRA believes that "…*the listed factors generally are relevant (and often crucial) to a suitability analysis, [then] the Rule requires firms and associated persons to document with specificity their reasonable basis for believing that a factor is not relevant in order to be relieved of the obligation to obtain information about that factor."* (emphasis added). As a word of caution, firms should attempt to obtain information about all of the factors set forth in the Rule, and not risk being challenged on their decision to omit any factor.

CONCLUSION

Regulatory Notice 11-02 is certainly one of the more important pronouncements FINRA has made relative to a broker-dealer's relationship with its customers. RRS strongly encourages firms to become thoroughly familiar with these new Rules and promptly make the necessary amendments to compliance policies and written supervisory procedures. All firms must be in compliance no later than October 7, 2011. Firms should also be diligent in providing their associated persons with the necessary training and education to make certain they are conversant and compliant with these new Rules.

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