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## COMPLIANCE CLARIFIED

### Preparing For FINRA's KYC and Suitability Rules

The Financial Industry Regulatory Authority's new know-your-customer and suitability rules, which take effect July 2012, will have a material impact on compliance and supervisory programs, training and data needs and are likely to require systems changes. FINRA published guidance for these rules in May.

#### Know Your Customer

New FINRA Rule 2090 requires firms to use "reasonable diligence" to know (and retain) the "essential facts" concerning a customer when opening and maintaining every account. The new KYC obligation arises at the start of the customer-broker relationship and does not depend on whether the broker has made a recommendation. The rule does not specify how frequently essential facts must be updated, but FINRA noted that customer information should be obtained "at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from a change in the customer's circumstances."

#### Suitability

FINRA Rule 2111 establishes new standards for suitability. This rule is notable for several reasons. For one, it materially expands the factors relevant to a suitability determination to include the investor's age, investment experience, time horizon, liquidity needs and risk tolerance. A broker does not need to assess every item in the investor profile; but a "reasonable basis" must exist "for believing that a factor is not relevant" to the suitability analysis. Furthermore, it covers investment strategies, including recommendations to hold securities, and clarifies that three suitability obligations exist: reasonable-basis suitability; customer-specific suitability; and quantitative suitability.

Regarding customer-specific suitability, there is an exception for an institutional account for which there is a reasonable basis to believe that the customer is capable of independently evaluating the risks of the recommended activity and "affirmatively indicates" that the customer is doing so.

#### Compliance Considerations

1. Assess current client information-gathering procedures to determine whether all suitability factors are being obtained and considered

before a securities recommendation is made. Enhance procedures and implement new processes accordingly. While FINRA's recent guidance clarified that the new suitability rule doesn't require updating all customer account documentation, documenting the additional information is good practice and consistent with other regulatory requirements.

2. Consider ways to aggregate systematically client data that exists in different parts of the firm or in various firm systems.
3. Determine how frequently client information will be updated, what process will be used to obtain updated information and how the process will be documented.
4. Determine how to deal with customers who do not provide information about all suitability elements. FINRA states that firms should exercise "reasonable diligence" in ascertaining this information. Consider what documentation is warranted to comply with this standard.
5. Identify changes required in hard copy and electronic forms, customer, financial adviser and supervisory tools and supervision and compliance programs, and work with technology staff to determine additional data and infrastructure needs.
6. Work with other areas of the firm to adopt and disseminate policies defining relevant terms, such as "recommendation" and "strategy."
7. Review existing language in customer agreements and other documents to determine if it might constitute a strategy recommendation and make any necessary changes.
8. Formulate processes for documenting and supervising recommendations, particularly those to hold securities.
9. Plan the changes needed in surveillance and monitoring systems to comply with new suitability requirements.
10. Determine the training necessary to educate the firm about the new rules and obligations.

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*The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.*

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