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Roadmap for implementing
US financial reform

Ten things a compliance officer should consider

In connection with the new FINRA suitability and KYC rules

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In January 2011, the SEC approved new FINRA Rule 2090 (Know-Your-Customer or KYC) and FINRA Rule 2111 (Suitability). The KYC and suitability obligations are viewed as key to investor protection and promoting fair dealing with customers and ethical sales practices. While adopted as part of FINRA's effort to consolidate related NYSE and NASD rulebooks, FINRA Rules 2090 and 2111 introduce broad new concepts to broker-dealers' KYC and suitability obligations.

The revamped rules take effect on 7 October 2011 and will have a material impact on compliance and supervisory programs, training and data needs, and likely will require systems changes. Because of the new rules' extensive nature, large scale and rapidly approaching compliance date, we have outlined several topics that compliance organizations should consider when evaluating the rules' impact on their firms.

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 rule states that "essential facts" are those facts required to:

- Effectively service the customer's account
- Act in accordance with any special handling instruction for the account
- Understand the authority of each person acting on behalf of the customer
- Comply with applicable laws, regulations and rules

The KYC obligation arises at the start of the customer-broker relationship and continues throughout the term of that relationship. The obligation does not depend on whether the broker has made a recommendation. As such, the new KYC rule changes the focus of the obligation from "orders" to customer relationships.

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While the KYC rule does not specify how frequently "essential facts" must be updated, 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." Although FINRA explained that the reasonableness of a broker's effort to update KYC information will depend on the facts and circumstances of the specific scenario, it further noted that SEC Rule 17a-3 currently mandates that brokers attempt to update account information for accounts in which it makes a suitability determination at least every three years.

Suitability

New FINRA Rule 2111 requires brokers to have a reasonable basis to believe that an explicit recommendation to buy, sell or hold securities, either individually or as part of an investment strategy, is suitable for the account based on the customer's investment profile.

According to FINRA, the suitability obligation arises when a broker makes a recommendation. In this regard, FINRA noted several guiding principles to assist in making this determination, specifically, 1) the content, context and presentation surrounding the communication, 2) whether the communication could reasonably be viewed as a suggestion for a customer to take or refrain from engaging in a specific action, and 3) the degree that the broker tailors the communication to a customer.

New FINRA Rule 2111 is notable for several reasons:

- It materially expands the existing list of factors (the "Investor Profile") relevant to the suitability determination to include age, investment experience, time horizon, liquidity needs and risk tolerance. While the new rule does expand the list of information that a broker must consider, FINRA noted that not every factor enumerated will be relevant to every suitability analysis. Consequently, FINRA explained that the new rule provides brokers flexibility, relieving the broker from its obligation to assess every item included on the Investor Profile, provided a "reasonable basis" exists "for believing that a factor is not relevant" to the suitability analysis.
- It covers investment strategies including recommendations to hold securities. It should be noted, however, that the rule does not cover certain categories of educational material.
- It clarifies that three specific suitability obligations must be complied with, which are:
  - Reasonable-basis suitability ("general product"): requires a broker to use reasonable diligence to obtain a reasonable belief that a particular security or investment strategy is suitable "for at least some investors"
  - Customer-specific suitability: requires the broker to have a reasonable basis that a security or investment strategy is suitable for a specific customer based upon the Investor Profile
  - Quantitative suitability ("frequency of trading"): requires a broker with either actual or de facto control over a customer account to have a reasonable basis that a series of transactions are suitable and not excessive based upon the Investor Profile

With respect to the customer-specific suitability obligation, an exception exists for institutional accounts where there is a reasonable basis to believe that the institutional customer is capable of independently evaluating the investment risks of the recommended security and "affirmatively indicates" that it is independently evaluating the recommendations.[1]

Compliance considerations

The introduction of these new rules has the potential to greatly impact existing compliance and supervisory programs, particularly with respect to retail customers (which includes high net worth individuals with less than $50 million in net worth). Below are 10 things a compliance officer should consider in preparing for the new regulations:

1. Assess current client information-gathering procedures to determine whether all 10 factors in FINRA Rule 2111(a) are being collected and documented. If not, enhance the relevant procedures and implement new processes so that the required suitability elements are documented prior to a recommendation being made. Procedures should also describe practices and documentation necessary to demonstrate that a broker has a reasonable basis for believing that a particular factor is not relevant to the suitability analysis. Develop a plan to obtain and document institutional customer acknowledgements.
2. A firm may find that it is in possession of all required Investor Profile data, but the information cannot be produced systematically. This may complicate compliance and supervisory activities, as well as the process of periodically updating the information. Accordingly, firms should consider ways to aggregate client data that may exist in different parts of the firm or in various firm systems.

[1] Even if a customer can meet the criteria of the institutional exemption, it does not relieve it from satisfying its reasonable-basis and quantitative suitability obligations.

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. Firms may decide to update all client's information at least every three years, update some set of clients more frequently or update information upon the occurrence of certain events. The process adopted should be clearly documented in the firm's policies and procedures.
4. Devise a plan to account for current and prospective customers who do not provide one or more of the Investor Profile elements in connection with the suitability determination. Prepare to document in writing why the information the customer declined to provide (or the firm chose not to obtain) is not relevant to a suitability determination and then create a process to apply and monitor. Absent a written record with clear support, the firm servicing a person who does not provide "essential facts" runs the risk of having to defend the suitability of its recommendations to the regulators. Also see that measures exist to maintain confidentiality of customer information.
5. Identify required changes to hard copy and electronic forms, customer, broker and supervisory tools and supervisory and compliance programs. Work with technology to identify additional data needs and infrastructure changes, including revisions to any surveillance and monitoring programs and take steps to back up data in case data is lost, deleted, stolen, etc.
6. Work with other areas of the firm (e.g., Legal) as relevant, adopt and disseminate policies defining the terms "recommendation" and "investment strategy," as well as any other concepts the firm deems important to suitability determinations so that brokers and others at the firm have similar understandings and expectations. Specifically with respect to the "recommendation" definition, compliance officers should enhance procedures to outline the guiding principles relevant to determining whether a broker has made a recommendation.
7. Review existing language in customer agreements and other documents to determine if such language could constitute a strategy recommendation. If so, change as warranted. Compliance officers should also review to see that agreements and documents are in "Plain English."
8. Formulate methods for documenting and supervising recommendations, especially those to "hold" securities.
9. Plan the changes to surveillance and monitoring systems which will be required to comply with quantitative suitability requirements beyond what is done today regarding churning and excessive trading.
10. Determine the scope of training of associated persons necessary to educate them about the new KYC and suitability requirements and their obligations.

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