

Know Your Customer and Suitability

New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations

Implementation Date: July 9, 2012

Executive Summary

On November 17, 2010, the Securities and Exchange Commission (SEC) approved FINRA's proposal to adopt rules governing know-your-customer and suitability obligations¹ for the consolidated FINRA rulebook.² On January 10, 2011, FINRA issued [Regulatory Notice 11-02](#), which provided guidance regarding the new rules and announced an implementation date. This *Notice* announces a new implementation date of July 9, 2012, and provides additional guidance in response to some recent industry questions and concerns.

Questions regarding this *Notice* should be directed to James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270.

Background

New FINRA Rule 2090 (Know Your Customer) requires firms to “use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer....” The rule explains that essential facts are “those required to (a) effectively service the customer’s account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.”³

May 2011

Notice Type

- ▶ Consolidated FINRA Rulebook
- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Know Your Customer
- ▶ Suitability

Referenced Rules & Notices

- ▶ Bank Secrecy Act
- ▶ FINRA Rule 2090
- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2130
- ▶ FINRA Rule 2264
- ▶ FINRA Rule 2270
- ▶ NTM 04-89
- ▶ NTM 05-26
- ▶ Regulatory Notice 09-31
- ▶ Regulatory Notice 11-02
- ▶ SEA Rule 17a-3

New FINRA Rule 2111 (Suitability) requires that a firm or associated person “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 through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.”⁴

In general, the new FINRA rules retain the core features of the previous NASD and NYSE rules covering the same subject areas and codify well-settled interpretations of those rules. A few aspects of the FINRA rules, however, have created new or modified obligations. Numerous firms asked that FINRA delay the implementation date to allow more time to prepare new or update current procedures, modify automated systems, and educate their associated persons regarding compliance with the new or modified requirements. Given these concerns and the significance of the rules to both the industry and the public, FINRA believes it is appropriate to provide firms with a reasonable extension of the implementation date to comply with the new or modified requirements. Accordingly, FINRA filed with the SEC a rule change effective immediately to delay the rules’ implementation date until July 9, 2012.⁵

Discussion

A number of firms have asked FINRA to provide additional guidance to assist them in preparing to comply with the new rules. The most frequently asked questions and FINRA’s answers are discussed below.⁶ FINRA reiterates, however, that many of the obligations under the new rules are the same as those under the predecessor rules and interpretations of those rules. FINRA emphasizes that existing guidance and interpretations regarding know-your-customer and suitability obligations continue to apply to the extent that they are not inconsistent with the new rules.

Know Your Customer

- Q1. Does the know-your-customer obligation to “understand the authority of each person acting on behalf of the customer” require a firm to know more than the names of the persons acting on behalf of the customer?**
- A1.** Rule 2090 generally requires a member firm to know the names of any persons authorized to act on behalf of a customer and any limits on their authority that the customer establishes and communicates to the member firm. FINRA understands, however, that some member firms may decide as a business practice to accept only those customers that do not qualify the scope of authority of persons acting on the customers’ behalf in their dealings with the member firms.

Suitability

Firms' questions regarding the new suitability rule have focused on information-gathering requirements in relation to a customer's investment profile, the scope of the term "strategy," and reasonable-basis obligations.

Customer's Investment Profile

- Q2. Does a firm have to update all customer-account documentation by the suitability rule's implementation date to capture the new "customer investment profile" factors (age, investment experience, time horizon, liquidity needs and risk tolerance) that were added to the existing list (other holdings, financial situation and needs, tax status and investment objectives)?⁷**
- A2.** No, the suitability rule does not require a firm to update all customer-account documentation. The rule requires that a broker seek to obtain⁸ and consider relevant customer-specific information when making a recommendation. Although a firm has a general obligation to evidence compliance with applicable FINRA rules, aside from the situation where a firm determines not to seek certain information (addressed in Question 3 below),⁹ Rule 2111 does not include any explicit documentation requirements.¹⁰ The suitability rule allows firms to take a risk-based approach with respect to documenting suitability determinations. For example, the recommendation of a large-cap, value-oriented equity security generally would not require written documentation as to the recommendation. In all cases, the suitability rule applies to recommendations, but the extent to which a firm needs to evidence suitability generally depends on the complexity of the security or strategy in structure and performance and/or the risks involved. Compliance with suitability obligations does not necessarily turn on documentation of the basis for the recommendation. However, firms should understand that, to the degree that the basis for suitability is not evident from the recommendation itself, FINRA examination and enforcement concerns will rise with the lack of documentary evidence for the recommendation. In addition, documentation by itself does not cure an otherwise unsuitable recommendation.
- Q3. Would a firm violate the suitability rule if it makes recommendations to customers for whom it has not obtained all of the customer-specific information listed in FINRA Rule 2111(a)?**
- A3.** The essential requirement of this provision is that the member firm or associated person exercise "reasonable diligence" to ascertain the customer's investment profile. In most instances, asking a customer for the information would constitute reasonable diligence. When customer information is unavailable despite a firm's reasonable diligence, however, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of the

recommendation. While the rule lists some of the aspects of a typical investment profile, not every factor may be relevant to all situations. Indeed, Supplementary Material .04 states that a member need not seek to obtain and analyze all of the factors if it “has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer’s investment profile in light of the facts and circumstances of the particular case.” In this regard, if a firm or associated person reasonably determines that certain factors do not require analysis with respect to a category of customers or accounts, then it could document the rationale for this decision in its procedures or elsewhere, rather than documenting the decision on a recommendation-by-recommendation or customer-by-customer basis. For example, a firm may conclude that age is irrelevant regarding all customers that are entities or liquidity needs are irrelevant regarding all customers for whom only liquid securities will be recommended.

The absence of some customer information that is not material under the circumstances generally should not affect a firm’s ability to make a recommendation. To meet its suitability obligations, a firm must obtain and analyze enough customer information to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information generally will depend on the facts and circumstances of the particular case, including the nature and characteristics of the product or strategy at issue.

Q4. How does FINRA define the terms “liquidity needs,” “time horizon” and “risk tolerance” for purposes of the suitability rule?

- A4.** FINRA Rule 2111 does not define the terms. As a general matter, these terms are to be understood commensurate with their meaning in financial analysis. FINRA, however, offers the following guidelines:
- ▶ **Liquidity Needs:** The extent to which a customer desires the ability or has financial obligations that dictate the need to quickly and easily convert to cash all or a portion of an investment or investments without experiencing significant loss in value from, for example, the lack of a ready market, or incurring significant costs or penalties.¹¹
 - ▶ **Time Horizon:** “[T]he expected number of months, years, or decades [a customer plans to invest] to achieve a particular financial goal.”¹²
 - ▶ **Risk Tolerance:** A customer’s “ability and willingness to lose some or all of [the] original investment in exchange for greater potential returns.”¹³

FINRA recognizes that there can be an inverse relationship between an investment time horizon and liquidity needs in that the longer a customer's time horizon, the less the need for liquidity. However, a customer may have a long time horizon, but also may need or want to invest all or a portion of his or her portfolio in liquid assets to pay for unexpected expenses or take advantage of unforeseen opportunities. Furthermore, although customers with a long time horizon generally may be in a position to seek greater returns by taking on greater risk because they "can wait out slow economic cycles and the inevitable ups and downs of" the markets,¹⁴ that is not always the case. Some customers with long time horizons may not desire to take on such risk and others, because of considerations outside their time horizons, are unable to do so.

- Q5. Can a customer with multiple accounts at a single firm have different investment profiles or investment-profile factors (e.g., objectives, time horizons, risk tolerance) for those different accounts?**
- A5.** A customer could proceed in such a manner, but a firm should evidence the customer's intent to use different investment profiles or investment-profile factors for the different accounts. Nothing in this guidance, however, relieves a firm from having to ensure that the investment profiles or factors accurately reflect the customer's decisions. In addition, where a firm allows a customer to use different investment profiles or factors for different accounts rather than using a single customer profile for all of the customer's accounts, a firm could not borrow profile factors from the different accounts to justify a recommendation that would not be appropriate for the account for which the recommendation was made.
- Q6. Does a firm have to use the exact rule terminology when seeking to obtain customer-specific information?**
- A6.** No. FINRA is aware that some firms currently ask customers for relevant information without using the exact rule terminology or separately designating factors (e.g., investment objectives that include a risk-tolerance component that is not separately labeled as such). Firms may continue to use such approaches. Firms must attempt to obtain and analyze relevant customer-specific information. Although firms should be capable of explaining how they are doing so and, where appropriate, evidencing that they are doing so, the rule does not dictate use of a specific method or process or of particular terminology.

Strategies**Q7. What is the scope of the term “strategy” as used in FINRA Rule 2111?**

- A7.** The rule explicitly states that the term “strategy” should be interpreted broadly.¹⁵ The rule would cover a recommended investment strategy regardless of whether the recommendation results in a securities transaction or even references a specific security or securities. For instance, the rule would cover a recommendation to purchase securities using margin¹⁶ or liquefied home equity¹⁷ or to engage in day trading,¹⁸ irrespective of whether the recommendation results in a transaction or references particular securities.

The term also would capture an *explicit* recommendation to *hold* a security or securities.¹⁹ While a decision to hold might be considered a passive strategy, an explicit recommendation to hold does constitute the type of advice upon which a customer can be expected to rely. An explicit recommendation to hold is tantamount to a “call to action” in the sense of a suggestion that the customer stay the course with the investment. The rule would apply, for example, when an associated person meets with a customer during a quarterly or annual investment review and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio. The rule, however, would not cover an implicit recommendation to hold.²⁰ The rule, for instance, would not apply where an associated person remains silent regarding, or refrains from recommending the sale of, securities held in an account. That is true regardless of whether the associated person previously recommended the purchase of the securities, the customer purchased them without a recommendation, or the customer transferred them into the account from another firm where the same or a different associated person had handled the account.²¹

Q8. What is the nature of the obligation under the suitability rule created by a hold recommendation?

- A8.** The new rule does not change the longstanding application of the suitability rule on a recommendation-by-recommendation basis. In general, the focus remains on whether the recommendation was suitable at the time when it was made. Absent an agreement, course of conduct or unusual fact pattern that might alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.²²

Q9. What is the scope of the provision in Supplementary Material .03 that excludes from the rule's coverage certain types of strategy-related communications that are educational in nature?²³

A9. What could be considered a "safe-harbor" provision in Supplementary Material .03 is limited in scope. Firms seeking to rely on the provision should take a conservative approach to determining whether a particular communication is eligible for such treatment. Any significant variation from the list in the safe-harbor provision would be subject to regulatory scrutiny. It is important to note, however, that the suitability rule would not apply to a firm's explanation of a strategy falling outside the safe-harbor provision if a reasonable person would not view the communication as a recommendation. Accordingly, the suitability rule would cover a firm's recommendation that a customer purchase securities using margin, whereas the rule generally would not cover a firm's brochure that simply explains the risks and benefits of margin without suggesting that the customer take action.²⁴

Q10. For purposes of the suitability rule, how should a firm document recommendations to hold in particular and recommendations of strategies more generally?

A10. As discussed above, aside from the instances when a firm determines not to seek certain information (addressed in Question 3), FINRA Rule 2111 does not impose explicit documentation requirements. Each firm has a general obligation to evidence compliance with applicable FINRA rules. A firm may use a risk-based approach to evidencing compliance with the suitability rule. In that context, a firm may want to focus on hold recommendations involving securities that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component, that have a periodic reset or similar mechanism that could alter the product's character over time, that are particularly susceptible to changes in certain market conditions, or that are otherwise potentially risky to hold at the time when the recommendations are made. A risk-based approach also may lead a firm to pay particular attention to hold recommendations where, at the time the recommendation is made, a customer's account has a heavy concentration in a particular security or industry sector or the security or securities in question are inconsistent with the customer's investment profile.²⁵ The same approach applies to other recommended strategies. In general, the more complex and risky the strategy, the more the firm using a risk-based approach should focus on the recommendation.

In regard to the type or form of documentation that may be needed, the facts and circumstances must inform that decision. Consistent with the discussions above, however, the complexity of and risks associated with a particular security or strategy likely will impact the level of documented analysis that is appropriate.

Reasonable-Basis Suitability

Q11. For purposes of compliance with the reasonable-basis obligation,²⁶ is it sufficient that a firm’s “product committee,” which conducts due diligence on products, has approved a product for sale?

A11. Although due diligence reviews by such committees can be extremely beneficial,²⁷ a firm’s approval of a product for sale does not necessarily mean that an associated person has complied with the reasonable-basis obligation. Reasonable-basis suitability has two main components: a broker must (1) perform reasonable diligence to understand the potential risks and rewards associated with a recommended security or strategy and (2) determine whether the recommendation is suitable for at least some investors based on that understanding. A broker can violate reasonable-basis suitability under either prong of the test. That is, even if a firm’s product committee has approved a product for sale, an individual broker’s lack of understanding of a recommended product or strategy could violate the obligation, notwithstanding that the recommendation is suitable for some investors.²⁸

A firm should educate its associated persons on the potential risks and rewards of the products that the firm permits them to recommend. In general, an associated person may rely on a firm’s fair and balanced explanation of the potential risks and rewards of a product. However, if the associated person remains uncertain about the potential risks and rewards of a product or has reason to believe that the firm failed to address a particular issue or has done so in an incomplete or inaccurate manner, then the associated person would need to engage in further inquiry before recommending the product.

Endnotes

- 1 See Securities Exchange Act Release No. 63325 (November 17, 2010), 75 FR 71479 (November 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039).
- 2 The current FINRA rulebook consists of (1) FINRA rules; (2) NASD rules; and (3) rules incorporated from NYSE (NYSE rules). While the NASD rules generally apply to all FINRA member firms, the NYSE rules apply only to those members of FINRA that also are members of the NYSE. The FINRA rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice, March 12, 2008](#) (Rulebook Consolidation Process).
- 3 FINRA Rule 2090.01.

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- 4 FINRA Rule 2111(a).
- 5 See Securities Exchange Act Release No. 64260 (April 8, 2011), 76 FR 20759 (April 13, 2011) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Delay the Implementation Date of FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability); File No. SR-FINRA-2011-016).
- 6 Nothing in this guidance shall be construed as altering in any manner a member firm's obligations under other applicable federal securities laws or FINRA rules, including SEA Rule 17a-3 and the Bank Secrecy Act, 31 U.S.C. §§ 5311, *et seq.*
- 7 See FINRA Rule 2111(a).
- 8 The term "obtained," as used in the rule's information-gathering section, does not require a firm to document the information in all instances.
- 9 See FINRA Rule 2111.04 (explaining that a firm that decides not to seek to obtain and analyze information about a customer-specific factor must document its reasonable basis for believing that the factor is not a relevant consideration).
- 10 FINRA notes that there are SEC and other FINRA rules that explicitly require specific types of documentation. See, e.g., SEA Rule 17a-3(a)(17)(i) (A) (discussing "books and records" requirements for certain account information, including, among other things, date of birth, employment status, annual income, net worth and investment objectives, regarding an account with a natural person as a customer). See also *supra* note 6.
- 11 For purposes of considering liquidity needs in the context of FINRA Rule 2111, examples of possible liquid investments include money market funds, Treasury bills and many blue-chip stocks, exchange-traded funds and mutual funds. FINRA emphasizes, however, that a high level of liquidity does not, in and of itself, mean that the recommended product is suitable for all customers. For instance, some relatively liquid products can be complex and/or risky and therefore unsuitable for some customers. See, e.g., [Regulatory Notice 09-31](#) (June 2009) (reminding firms of their sales-practice obligations relating to leveraged and inverse exchange-traded funds).
- 12 See www.sec.gov/investor/pubs/assetallocation.htm.
- 13 *Id.*
- 14 *Id.*
- 15 See FINRA Rule 2111.03.
- 16 For certain requirements related to margin, see FINRA Rule 2264.
- 17 See [Notice to Members \(NTM\) 04-89](#) (December 2004) (reminding firms that "recommending liquefying home equity to purchase securities may not be suitable for all investors and that [firms] should perform a careful analysis to determine whether liquefying home equity is a suitable strategy for an investor").
- 18 For certain requirements related to day trading, see FINRA Rules 2130 and 2270.
- 19 See FINRA Rule 2111.03.

- 20 See FINRA Rule 2111.03. In limited circumstances, FINRA and the SEC have recognized that certain actions constitute implicit recommendations that can trigger suitability obligations. For example, FINRA and the SEC have held that associated persons who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule. See, e.g., *Rafael Pinchas*, 54 S.E.C. 331, 341 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended). Although such holdings continue to act as precedent regarding those issues, the new rule does not broaden the scope of *implicit* recommendations. The new rule does not apply to *implicit* recommendations to *hold*.
- 21 Firms also have asked whether the absence of a sell order in a discretionary account amounts to an implicit hold recommendation covered by the rule. *To the extent that a customer account at a broker-dealer can be discretionary under applicable federal securities laws*, the suitability rule generally would not apply where a firm refrains from selling a security. The rule states that it applies to *explicit* recommendations to hold. See FINRA Rule 2111.03. Unless the facts indicate that an associated person's failure to sell securities in a discretionary account was intended as or tantamount to an explicit recommendation to hold, FINRA would not view the associated person's inaction or silence in such circumstances as a recommendation to hold the securities for purposes of the suitability rule.
- 22 Similarly, and as noted previously, the absence of a recommendation to sell would not amount to a hold recommendation subject to the rule.
- 23 See FINRA Rule 2111.03.
- 24 [Regulatory Notice 11-02](#) (January 2011) discusses several guiding principles that are relevant to determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule.
- 25 As discussed in Question 8 above, absent an agreement, course of conduct or unusual fact pattern that might alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.
- 26 See FINRA Rule 2111.05(a).
- 27 See, e.g., [NTM 05-26](#) (April 2005) (recommending best practices for reviewing new products).
- 28 See FINRA Rule 2111.05(a). This position is consistent with requirements under the previous suitability rule. In *Dep't of Enforcement v. Siegel*, for instance, FINRA's National Adjudicatory Council explained that a "recommendation may lack 'reasonable-basis' suitability if the broker: (1) fails to understand the transaction, which can result from, among other things, a failure to conduct a reasonable investigation concerning the security; or (2) recommends a security that is not suitable for any investors." *Dep't of Enforcement v. Siegel*, No. C05020055, 2007 NASD Discip. LEXIS 20, at *38 (NAC May 11, 2007), *aff'd*, Exchange Act Release No. 58737, 2008 SEC LEXIS 2459 (Oct. 6, 2008), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 2010 U.S. LEXIS 4340 (May 24, 2010).