

FINRA gives member firms a thumbs up on suitability rule compliance

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Abstract

Purpose – *The purpose of this paper is to interpret Financial Industry Regulatory Authority (FINRA) Regulatory Notice 13-31, which provides practical advice to member firms about how FINRA will be examining for compliance with the rule, some findings about failures to comply and a set of best practices for compliance.*

Design/methodology/approach – *The paper explains the three suitability obligations set forth in Rule 2111, the mechanics of FINRA's suitability examinations, overall findings from FINRA's recent suitability examinations, and some measures and practices FINRA has highlighted that could bolster a firm's suitability-focused supervisory and compliance procedures.*

Findings – *The Notice provides a wealth of information on the types of approaches, systems, procedures and practices that member firms have been using and that FINRA has determined to be most effective in ensuring compliance with the suitability rule.*

Practical implications – *Although other ways to comply with the rule certainly exist, member firms should review the Notice and consider incorporating the practices discussed or practices likely to achieve similar outcomes.*

Originality/value – *The paper provides practical guidance from experienced financial services lawyers.*

Keywords *United States of America, Financial Industry Regulatory Authority (FINRA), Suitability*

Paper type *Technical paper*

Having issued a new suitability rule and explicated it for the industry, on September 25, 2013, the Financial Industry Regulatory Authority (FINRA) took the next step and issued *Regulatory Notice 13-31*[1] (“Notice”), providing practical advice to member firms about how it will be examining for compliance with the rule, some findings about failures to comply and a set of best practices for compliance. The good news is that FINRA's examinations have found that firms for the most part have adopted policies, procedures and systems to address the requirements of the suitability rule. Moreover, firms have been very responsive to FINRA's feedback resulting from exams by addressing deficiencies.

The Notice and the practices highlighted therein are envisioned by FINRA to be “positive steps in building a strong compliance environment.” FINRA encourages firms to carefully consider the practices discussed in the Notice in the near term to determine whether additional efforts are required to improve the suitability determination and supervision process, rather than wait for a regulatory examination that finds their practices to be wanting. To help firms adjust to the new rule, we will summarize FINRA's findings and best practices.

Setting the stage: suitability rule requirements

Rule 2111, effective as of July 9, 2012, pulled together into one rule FINRA's prior suitability rule together with case law established by FINRA and other policy-related enhancements. The rule imposes three suitability obligations:

1. *Reasonable-basis analysis* requires a firm or associated person to perform reasonable diligence to understand the nature of a recommended security or investment strategy involving a security, its potential risks and rewards, and determine whether a recommendation for investment in that security is suitable for any investors;
2. *Customer-specific analysis* requires a firm or associated person to have a reasonable basis to believe that an investment recommendation is suitable for a particular customer, based on the customer's investment profile; and
3. *Quantitative analysis* requires a firm or associated person with actual or de facto control over a customer account to have a reasonable basis to believe that a series of recommended transactions, even if individually suitable, are not excessive when viewed collectively.

The rule applies suitability determinations to explicit recommendations to "hold" a security and recommended investment strategies, in addition to recommendations to buy or sell a security. The rule adds new customer investment profile factors (age, investment experience, time horizon, liquidity needs and risk tolerance) to the previous list (other holdings, financial situation and needs, tax status and investment objectives) and provides an exemption to customer-specific suitability for recommendations to institutional customers if certain criteria are met.

A glimpse behind the curtain: the mechanics of FINRA's suitability examinations

The Notice reveals that FINRA examiners start analyzing suitability rule compliance by analyzing a firm's controls, that is, its policies and procedures, in light of the products sold and customers served, and its readiness to control risks related to suitability. The depth and breadth of such testing is determined by the supervisory systems and controls already developed, the products and strategies recommended by the firm, its business activities and customer base and other relevant information.

Member firms should expect that examiners will seek suitability-related information on topics such as:

- training offered regarding suitability rule amendments, and investment strategy and hold recommendations;
- investment strategy definition and supervision;
- supervisory and compliance procedures for reasonable-basis, customer-specific and quantitative suitability;
- tools used to identify in-and-out trading and high turnover rates and commission-equity ratios;
- institutional account determinations; and
- determination of portfolio analytic tools or models' compliance with the suitability rule or their qualification for a safe harbor.

After FINRA examiners obtain this information, they review firm controls to determine whether firm procedures are being followed, and may expand the scope of the examination to analyze material deviations between procedures and practices. Examiners may also review transactions and related suitability documentation when there are red flags raised as to potential unsuitable recommendations. Red-flag transactions could be those that: appear to deviate from the firm's internal suitability guidelines for a particular security; provide a long-term investment for an investor with a short-term horizon; constitute a speculative investment or strategy held in the account of an investor with a conservative investment objective; or indicate that the same security was held in the account or the same strategy was implemented for multiple investors of a particular representative despite differing customer profiles.

Plaudits and pans: findings from FINRA's suitability examinations

While noting that the suitability rule was amended only recently, and that many firms have not been examined since those amendments became effective, the Notice concluded that most firms examined to date have updated policies, procedures and systems, trained staff and obtained additional customer investment profile information. At the same time, a small percentage of firms examined have not taken "a comprehensive approach to best ensure compliance with the rule." The most frequent deficiency noted consisted of inadequate procedures for supervising and documenting hold recommendations. FINRA disposed of the vast majority of examinations with deficiencies through an informal Cautionary Action, while it referred a few examination findings involving suitability violations actionable under the predecessor suitability rule to FINRA's Enforcement Department.

Practice makes perfect: effective practice observations

While acknowledging that there is no one-size-fits-all approach to compliance and supervision, the Notice highlighted some measures and practices that could bolster a firm's suitability-focused supervisory and compliance procedures.

Reasonable-basis suitability analysis

FINRA found that many firms have implemented a new product vetting process in an effort to adhere to the rule's reasonable-basis suitability review requirements. While observing that the new product vetting process alone does not satisfy the associated persons' obligations to understand the securities and investment strategies recommended to customers, FINRA reported approvingly that some firms post to internal websites documents related to product due diligence, such as audited financial statements, notes of interviews with key product sponsor or issuer personnel and other information on the product and its features. Associated persons may consult these documents prior to making investment recommendations. Additionally, some firms require associated persons to complete instructor-led or online training prior to engaging in the sale of an approved product and may even require them to pass a test at the conclusion of the training.

Customer-specific suitability analysis

The Notice found that many firms began collecting additional information for new customers and supplementing existing customer investment profile information prior to the effective date of the amended rule by updating account forms and using electronic customer relationship management systems to capture this information. FINRA also found that firms made significant technological changes to internal systems to capture the added customer profile data. Some firms have even prohibited recommended transactions unless the customer fully completed or updated account information with all of the factors listed in the amended rule.

Firms have also implemented new policies and exception systems flagging vulnerable investors, such as those unable to sustain more than limited losses, individuals near or in retirement or other investors who rely on an income stream from an investment portfolio.

Quantitative suitability analysis

FINRA learned that to comply with the quantitative suitability provision of the rule, most firms had already been monitoring customer accounts for churning and excessive trading. Some firms upgraded their surveillance and monitoring systems, and exception reports, by integrating additional customer profile information. Going forward, FINRA recommended that firms evaluate their compensation arrangements to determine whether they incentivize a sales person to engage in unsuitable excessive trading, or to make unsuitable recommendations.

The institutional-customer exemption

While some firms with an institutional customer base use tailored account opening documents, others use separate forms or certifications to facilitate compliance with the institutional-customer exemption. In these documents, the institutional customer acknowledges in writing that it will exercise independent judgment in evaluating recommendations. Other firms obtain the affirmative indication through conversations with their institutional customers and then document those conversations. Yet other firms use third-party vendors to verify the institutional status and sophistication of customers.

Hold and other investment strategy recommendations

FINRA learned that the “hold” and “investment strategy” aspects of the suitability rule created behavioral and cultural challenges for firms, since it was not previously customary for registered representatives to consider an explicit hold as a recommendation or to document a strategy. Therefore, many firms provided initial and ongoing training on this aspect of the rule, while other firms were deficient in adapting to the new requirement.

FINRA acknowledged systems some firms adopted to achieve compliance with the hold and strategy requirements, including: a “hold ticket” or “hold blotter” capturing the hold and other types of strategy recommendations; notes of conversations with clients regarding explicit hold or other strategy recommendations, including the use by some small firms of clearing firm platforms to capture explicit hold recommendations or other strategies; branch office inspections focusing on the documentation of the hold and other strategy conversations with clients; revised new account forms that include specific investment strategies; new or amended account opening forms signed by the customer when the associated person recommends changes to a previous account investment strategy; and a prohibition on associated persons engaging firm clients in their outside business activities.

Supervision and compliance

FINRA examinations indicated that an effective and reasonable system of supervision and compliance over the areas covered by the suitability rule delineates who is responsible for conducting a specific review, what will be reviewed, the frequency of reviews and the documentation required to evidence the review. To detect potential red flags, some small firms look beyond an individual customer’s account, at concentrated positions of a security in the accounts serviced by specific registered representatives or across customer accounts or branch offices for an accumulation of a security that is not readily explained (e.g. a security not followed by the firm). These red flags may then become the subject of review by the firm.

Conclusion

The Notice provides a wealth of information on the types of approaches, systems, procedures and practices that member firms have been using and that FINRA has determined to be most effective in ensuring compliance with the suitability rule. Although other ways to comply with the rule certainly exist, member firms should review the Notice and consider incorporating the practices discussed or practices likely to achieve similar outcomes.

Note

1. www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p351220.pdf

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