2016 FINRA/SIFMA Senior Investor Protection Conference

Washington, DC | October 20-21, 2016

Suitability Considerations and Sales Practices for Senior Investors
Friday, October 21
9:45 a.m. – 10:45 a.m.

When serving senior clients, it is important for a firm's procedures and controls to properly gauge the suitability of recommendations to senior investors and ensure clear, straightforward sales practices. This panel of experts examines the FINRA suitability rule (2111), the rule's potential interplay with cognitive decline, the importance of ensuring client understanding of risks and other issues of which firms should be aware.

Moderator:

James S. Wrona
Vice President and Associate General Counsel
FINRA Office of General Counsel

Panelists:

Cara Aber
Executive Director & Assistant General Counsel
J.P. Morgan Securities LLC

James Muir
Executive Director, Investments Compliance
USAA

Aisling Murphy
Senior Compliance Manager
Vanguard Group, Inc.

Donald Runkle
Regulatory Compliance Director
Coordinated Capital Securities, Inc.

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Suitability Considerations and Sales Practices for Senior Investors Panelist Bios:

Moderator:

James S. Wrona is Vice President and Associate General Counsel for FINRA in Washington, DC. In this role, he is responsible for various policy initiatives, rule changes and litigation regarding the securities industry. Mr. Wrona formerly was associated with the law firm of K&L Gates LLP, where his practice focused on complex federal litigation. He also previously served as a federal law clerk for the Honorable A. Andrew Hauk of the United States District Court for the Central District of California (Los Angeles). Mr. Wrona is a frequent speaker at securities and litigation conferences and author of numerous law review articles, including The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection, 68 Bus. Law. 1 (Nov. 2012); The Securities Industry and the Internet: A Suitable Match?, 2001 Colum. Bus. L. Rev. 601 (2001).

Panelists:

Cara Aber is Executive Director and Assistant General Counsel with J.P. Morgan Securities. Ms. Aber has more than 21 years of experience in the Securities Industry including several years in a litigation role and for the last 15 years as a legal advisor to private client wealth management divisions. She began her career at Bear Stearns & Co where she became a Managing Director advising the Private Client Services business on broker-dealer laws, rules and regulations as well as on transactional real-life/real-time risk assessment and determination decisions. For the last several years she has advised J.P. Morgan's Global Wealth Management division and has been the primary point of contact for her line of business for a number of client segments including Senior Investor/Vulnerable Adult, ADA, SCRA, and UDAAP client issues, policies, procedures and escalation through resolution. Ms. Aber is a member of a number of firm wide J.P Morgan internal working groups covering Senior Investor/Vulnerable Adult initiatives and the assessment and implementation of policies and procedures related to new laws, rules, regulations and best practices. She is an active participant of several industry groups including the SIFMA Senior Investor Working group. Ms. Aber is a graduate of Brandeis University and received her J.D. from St. John's University School of Law.

James Muir is currently an Executive Director in USAA's Investments Compliance Department and focuses primarily on issues pertaining to investments distribution. Prior to his current role, Mr. Muir was a senior attorney in USAA's Financial Advice and Solutions Group supporting USAA's securities and investment advisory businesses. Before joining USAA in 2014, Mr. Muir spent over 14 years at The Bank of New York Mellon Corporation in various compliance and legal roles. Most recently, Mr. Muir was a Senior Counsel and Managing Director with responsibility for providing advice on all aspects of product distribution, including mutual funds, hedge funds and managed accounts, and he supported a BNY Mellon broker-dealer/investment adviser firm as its Chief Legal Officer. Prior to BNY Mellon, Mr. Muir held compliance roles at Prudential Financial, including in Newark, New Jersey and Jacksonville, Florida. Mr. Muir is in the U.S. Army Reserve and is currently assigned to a unit at Fort Sam Houston, Texas.

Aisling Murphy is Senior Compliance Manager responsible for broker-dealer compliance at Vanguard. She and her team are responsible for brokerage trading and operations, advertising compliance, retail distribution, sales and marketing, and licensing and registration. Prior to joining Vanguard in April 2015, Ms. Murphy held legal and compliance roles supporting broker-dealer, advisor services, and investment advisory activities at Edward Jones and Scottrade Inc. Ms. Murphy began her career as a criminal and civil litigator in St. Louis, Missouri. Ms. Murphy is a member of the SIFMA Compliance and Regulatory Policy Committee. She obtained her B.A. in English Literature from the University of Dallas in 1998 and her J.D. from St. Louis University in 2002.

Don Runkle is the Regulatory Compliance Director for Coordinated Capital Securities, Inc., and he is also the Director of Consulting Services with Edgerton & Weaver, LLP. Mr. Runkle works with broker-dealers, investment advisers, and registered representatives to develop, implement, and execute strategies to mitigate or eliminate their litigation and regulatory risks. In his role with Coordinated Capital Securities, he helps to ensure that the firm has appropriate processes and procedures to exceed all regulatory requirements and manage risks in an efficient and effective fashion. He also

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assists with the execution of all procedures as necessary, including support functions in examinations, regulatory inquiries, customer complaints, options activities, municipal bond activities, new and ongoing product reviews, suitability analyses, and general operational and compliance functions. Mr. Runkle was previously the Chief Compliance Officer for Raymond James Financial Services, Inc., in St. Petersburg, Florida. He has more than 25 years of experience in the financial services industry, having worked as a financial advisor and in several compliance-related roles. Mr. Runkle has been an active leader in numerous industry associations and regulatory committees. He currently serves on the FINRA Membership Committee, and he was previously elected to two terms on the FINRA District 7 Committee. He has also served on the FINRA Regulatory Advisory Committee, the SIFMA Compliance and Regulatory Policy Committee, the FSI Compliance Council, and the SIFMA Compliance and Legal Society's Regional Firms Committee. Previous industry involvement also includes the FINRA Compliance Resources and Education Committee, the FINRA Books and Records Task Force, the NASD Licensing and Registrations Council, the SIFMA Self-Regulations and Supervisory Practices Committee, the SIFMA State Regulation and Legislation Committee, and the IAFP Compliance Advisory Council. He holds numerous industry licenses, including the Series 7, 24, 53, 4, 63, 65, and previously obtained the Florida Life and Health insurance license. Mr. Runkle also completed the Securities Industry Institute at the University of Pennsylvania Wharton School in 2004, and he has been a FINRA arbitrator since 1998.

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Resources

FINRA Resources

- FINRA Rule 2111 (Suitability)

  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859

- FINRA Rule 2090 (Know Your Customer)

  http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13389&element_id=9858&highlight=2090%20-%20r13389

- FINRA *Regulatory Notice 15-37, Financial Exploitation of Seniors and Other Vulnerable Adults* (October 2015)

  www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-37.pdf

- FINRA *Regulatory Notice 12-55, Guidance on FINRA's Suitability Rule* (December 2012)

  www.finra.org/sites/default/files/NoticeDocument/p197435.pdf

- FINRA *Regulatory Notice 12-25, Additional Guidance on FINRA's New Suitability Rule* (May 2012)

  www.finra.org/sites/default/files/NoticeDocument/p126431.pdf

- FINRA *Regulatory Notice 11-25, Know Your Customer and Suitability* (May 2011)

  www.finra.org/sites/default/files/NoticeDocument/p123701.pdf

- FINRA *Regulatory Notice 11-02, Know Your Customer and Suitability* (January 2011)

  www.finra.org/sites/default/files/NoticeDocument/p122778.pdf

- FINRA *Regulatory Notice 07-43, Senior Investors* (September 2007)

  www.finra.org/sites/default/files/NoticeDocument/p036816.pdf

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Regulatory Notice 15-37

Financial Exploitation of Seniors and Other Vulnerable Adults

FINRA Requests Comment on Rules Relating to Financial Exploitation of Seniors and Other Vulnerable Adults

Comment Period Expires: November 30, 2015

Executive Summary

FINRA seeks comment on proposed rules addressing the financial exploitation of seniors and other vulnerable adults. FINRA is proposing: (1) amendments to FINRA Rule 4512 (Customer Account Information) to require firms to make reasonable efforts to obtain the name of and contact information for a trusted contact person for a customer's account; and (2) the adoption of new FINRA Rule 2165 (Financial Exploitation of Specified Adults) to permit qualified persons of firms to place temporary holds on disbursements of funds or securities from the accounts of specified customers where there is a reasonable belief of financial exploitation of these customers.

The proposed rule text is available in Attachment A.

Questions regarding this *Notice* should be directed to:

- James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270;
- Ann-Marie Mason, Director and Counsel, Shared Services, at (202) 728-8231; or
- Jeanette Wingler, Assistant General Counsel, OGC, at (202) 728-8013.

FINRA

Financial Industry Regulatory Authority

October 2015

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics

- Customer Accounts
- Financial Exploitation
- Senior and Vulnerable Adult Investors
- Temporary Holds on Disbursements
- Trusted Contact Persons

Referenced Rules

- FINRA Rule 4512
- Proposed FINRA Rule 2165
- SEA Rule 17a-3

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by November 30, 2015.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[1]

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[2]

Background & Discussion

FINRA's experience with its Securities Helpline for Seniors™ has highlighted issues relating to financial exploitation of this group of investors.[3] Among these issues is a firm's ability to quickly and effectively address suspected financial exploitation of seniors and other vulnerable adults consistent with FINRA rules. Currently, FINRA rules do not explicitly permit firms to contact a non-account holder or to place a temporary hold on disbursements of funds or securities where there is a reasonable belief of financial exploitation of a senior or other vulnerable adult.

To address these issues, FINRA is proposing rules to provide firms with a way to respond to situations in which they have a reasonable basis to believe that financial exploitation of vulnerable adults has occurred, is occurring, has been attempted or will be attempted.[4] FINRA believes that a firm can better protect its customers from financial exploitation if the firm can: (1) place a temporary hold on a disbursement of funds or securities from a customer's account; and (2) notify a customer's trusted contact (or, if unavailable, immediate family member) of the firm's decision to place the temporary hold on a disbursement from the customer's account.

Proposed Rules

Trusted Contact Person—Proposed Amendments to Rule 4512

FINRA is proposing to amend Rule 4512 to require firms to make reasonable efforts to obtain the name of and contact information for a trusted contact person upon the opening of a non-institutional customer's account.[5] The proposal does not prohibit firms from opening and maintaining an account if a customer fails to identify a trusted contact as long as the firm made reasonable efforts to obtain it. FINRA believes that asking a customer to provide the name and contact information for a trusted contact person ordinarily would constitute reasonable efforts to obtain the information and would satisfy the proposed rule's requirements.

Consistent with the current requirements of Rule 4512, a firm would not need to attempt to obtain the name of and contact information for a trusted contact person for currently existing accounts until such time as the firm updates the information for the account either in the course of the firm's routine and customary business or as otherwise required by applicable laws or rules. With regard to updating the contact information once provided, FINRA believes that firms should consider asking the customer to review and update the name of and contact information for a trusted contact person periodically, such as when updating account information pursuant to SEA Rule 17a-3, or when there is a reason to believe that there has been a change in the customer's situation.[6]

FINRA intends the trusted contact person to be a resource for the firm in administering the customer's account and in responding to possible financial exploitation. The proposed rule would require that the trusted contact person be age 18 or older and not be authorized to transact business on behalf of the account. A firm may elect to notify an individual that he or she was named as a trusted contact person; however, the proposed rule would not require notification.

The proposed rule would also require that, at the time of account opening, a firm shall disclose in writing (which may be electronic) to the customer that the firm or an associated person is authorized to contact the trusted contact person and disclose information about the customer's account to confirm the specifics of the customer's current contact information, health status, and the identity of any legal guardian, executor, trustee or holder of a power of attorney, and as otherwise permitted by proposed Rule 2165. In addition, a firm would be required to provide this disclosure when it attempts to obtain the name of and contact information for a trusted contact person when updating information for currently existing accounts either in the course of the firm's routine and customary business or as otherwise required by applicable laws or rules. Firms would be required to provide this disclosure at account opening or when updating information for currently existing accounts, even if a customer fails to identify a trusted contact. As noted below, pursuant to proposed Rule 2165, when information about a trusted contact person is

available, a firm must attempt to notify the trusted contact person that the firm has placed a temporary hold on a disbursement of funds or securities from a customer's account, unless the firm reasonably believes that the trusted contact person is engaged in the financial exploitation.[7]

Temporary Hold on Disbursement of Funds or Securities—Proposed New Rule 2165

FINRA is also proposing to permit "qualified persons" who reasonably believe that financial exploitation is occurring to place temporary holds on disbursements of funds or securities from the accounts of "specified adult" customers. Proposed Rule 2165 creates no obligation to withhold disbursement of funds or securities where financial exploitation may be occurring. Accordingly, Supplementary Material to proposed Rule 2165 would expressly state that the rule provides firms with a safe harbor when they exercise discretion in placing temporary holds on disbursements of funds or securities from the account of a specified adult under the circumstances denoted in the rule. It would further state that the rule does not require firms to place temporary holds on disbursements of funds or securities from the account of a specified adult.[8]

FINRA believes that "specified adults" may be particularly susceptible to financial exploitation.[9] Proposed Rule 2165 would define "specified adult" as: (A) a natural person age 65 and older;[10] or (B) a natural person age 18 and older who the firm reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests. Supplementary Material to proposed Rule 2165 would provide that a firm's reasonable belief that a natural person age 18 and older has a mental or physical impairment that renders the individual unable to protect his or her own interests may be based on the facts and circumstances observed in the firm's business relationship with the person.[11]

The proposed rule would denote the persons who can place a temporary hold on a disbursement as "qualified persons," which would mean associated persons of a firm who serve in supervisory, compliance or legal capacities that are reasonably related to the account of the specified adult. The proposed rule would define the term "account" to include any account of a firm for which a specified adult has the authority to transact business.

FINRA has proposed a broad definition of "financial exploitation." Specifically, financial exploitation would include: (A) the wrongful or unauthorized taking, withholding, appropriation, or use of a specified adult's funds or securities; or (B) any act or omission taken by a person, including through the use of a power of attorney, guardianship, or any other authority, regarding a specified adult, to: (i) obtain control, through deception, intimidation or undue influence, over the specified adult's money, assets or property; or (ii) convert the specified adult's money, assets or property.

Proposed Rule 2165 would permit a qualified person to place a temporary hold on a disbursement of funds or securities from the account of a specified adult if the qualified person reasonably believes that financial exploitation of the specified adult has occurred, is occurring, has been attempted or will be attempted.[12] If a firm places such a hold, the proposed rule would require the firm to immediately initiate an internal review of the facts and circumstances that caused the qualified person to reasonably believe that financial exploitation of the specified adult has occurred, is occurring, has been attempted or will be attempted. In addition, the proposed rule would require the firm to provide notification of the hold and the reason for the hold to all parties authorized to transact business on the account and, if available, the trusted contact person, no later than two business days after placing the hold. While oral or written (including electronic) notification would be permitted under the proposed rule, a firm would be required to retain records evidencing the notification.

If the trusted contact person is not available or the firm reasonably believes that the trusted contact person has engaged, is engaged or will engage in the financial exploitation of the specified adult, the proposal states that the firm shall attempt to contact an immediate family member,[13] unless the firm reasonably believes that the immediate family member has engaged, is engaged or will engage in the financial exploitation of the specified adult. For purposes of proposed Rule 2165, FINRA would consider the lack of an identified trusted contact person, the inability to contact the trusted contact person or a person's refusal to act as a trusted contact person to mean that the trusted contact person was not available. The same is true of an immediate family member. A firm may use the temporary-hold provision under proposed Rule 2165 when a trusted contact or an immediate family member is not available.

While the proposed rule does not require notifying the customer's registered representative of suspected financial exploitation, a customer's registered representative may be the first person to detect potential financial exploitation. If the detection occurs in another way, a firm may choose to notify and discuss the suspected financial exploitation with the customer's registered representative, unless the firm suspects that the registered representative is involved in the financial exploitation.

The temporary hold authorized by proposed Rule 2165 would expire not later than 15 business days after the date that the qualified person first placed the temporary hold on the disbursement of funds or securities, unless sooner terminated or extended by an order of a court of competent jurisdiction. In addition, provided that the firm's internal review of the facts and circumstances supports its reasonable belief that the financial exploitation of the specified adult has occurred, is occurring, has been attempted or will be attempted, the proposed rule permits the temporary hold to be extended by a qualified person for an additional 15 business days, unless sooner terminated by an order of a court of competent jurisdiction.

Proposed Rule 2165 would require firms to retain records related to compliance with the rule, which shall be readily available to FINRA, upon request. The retained records shall include records of: (1) requests for disbursement that may constitute financial exploitation of a specified adult and the resulting temporary hold; (2) the finding of a reasonable belief that financial exploitation has occurred, is occurring, has been attempted or will be attempted underlying the decision to place a temporary hold on a disbursement; (3) notification(s) to the relevant parties pursuant to the rule; and (4) the internal review of the facts and circumstances supporting the qualified person's reasonable belief that the financial exploitation of the specified adult has occurred, is occurring, has been attempted or will be attempted.

The proposed rule would require a firm that anticipates using a temporary hold in appropriate circumstances to establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the rule, including, but not limited to, procedures on the identification, escalation and reporting of matters related to financial exploitation of specified adults. The proposed rule would also require firms to develop and document specific training policies or programs reasonably designed to ensure that registered persons comply with the requirements of the rule.

Economic Impact Assessment

FINRA's experience with its Securities Helpline for Seniors has reaffirmed its understanding of the risks to customers of financial exploitation. The proposed rules are intended to further the protection of potentially at-risk customers by relieving firms from those FINRA rules that might otherwise discourage firms from exercising discretion to protect customers through placing a temporary hold on disbursements of funds or securities. Such a hold, combined with contact with a trusted person, also may permit these customers to stop unwanted disbursements and better protect themselves from financial exploitation.

The proposed rules not only better safeguard customers, to the extent that firms today do not provide protections for specified adults, but also better protect those firms that are already doing so.

The proposed amendments to Rule 4512 would require firms to attempt to collect information about a trusted person at the time of account opening or in the course of updating information for the account. Firms also would incur additional responsibilities to provide disclosure about the firm's right to share certain private information with the customer's trusted contact.

In addition, there may be significant impacts with respect to legal risks and attendant costs to firms that choose to rely on the proposed rule in placing temporary holds on disbursements; although the direction of the impact is ambiguous. The proposed rules

may provide some legal protection to firms if they are sued for withholding disbursements where there is a reasonable belief of financial exploitation. At the same time, while proposed Rule 2165 creates no obligation to withhold disbursement where financial exploitation may be occurring or to refrain from opening or maintaining an account where no trusted contact is identified, this proposed rule might serve as a rationale for a private action against firms that do not withhold disbursements when there is a reasonable belief of financial exploitation. To reduce the latter risk, proposed Rule 2165 would explicitly state that it provides firms with a safe harbor when they exercise discretion in placing temporary holds on disbursements of funds or securities, but would not require firms to place such holds.

To the extent that firms today have reasons to suspect financial exploitation of their customers, they may make judgments with regard to making or withholding disbursements of funds or securities. As such, these firms may already face litigation risk with regard to their actions, whether or not they choose to disburse funds or securities.

Request for Comment

In addition to generally requesting comments, FINRA specifically requests comment on the following questions:

1. Should the scope of the proposed rules be expanded to encompass other requirements?
2. Are there approaches other than the proposed rulemaking that FINRA should consider?
3. Should Rule 4512 require customer consent to contact the trusted contact or is customer notice sufficient? Should the types of information that may be disclosed to the trusted contact under Rule 4512 be modified?
4. What are firms' current practices when they suspect financial exploitation has occurred, is occurring, has been attempted or will be attempted? Would the proposed rules change firms' current practices?
5. What are firms' views on any potential legal risks associated with placing or not placing temporary holds on disbursements of funds or securities at present and under the proposal?
6. Should the ages used in the definition of "specified adult" in proposed Rule 2165 be modified or eliminated?
7. Should the definition of "account" be expanded to include accounts for which a specified adult is a named beneficiary?
8. Should the scope of the persons included in the definition of "qualified person" in proposed Rule 2165 be modified?

9. Is the two business day period for notifying the appropriate parties under proposed Rule 2165 appropriate? If not, what circumstances may warrant a shorter or longer period?
10. Should the permissible time periods for placing and extending a temporary hold pursuant to proposed Rule 2165 be modified?
11. Should FINRA mandate specific procedures for escalating matters related to financial exploitation?

FINRA also specifically requests comments on the economic impact and expected beneficial results of the proposed rules.

12. What direct costs for the firm will result from the proposed rules?
13. What indirect costs will arise for the firm from the proposed rules?
14. Will the proposed rules impose different costs on firms of different sizes or with different business models?
15. What benefits will result for customers from the proposed rules? How extensive are these benefits?
16. What costs for customers will result from the proposed rules?
17. Are the costs imposed by the rules warranted by the potential benefit to customers arising from the proposed rules?
18. How will the proposed rules change business practices and competition among firms? Will these impacts differently affect small or specialized broker-dealers?
19. Are there other means or mechanisms to efficiently and effectively provide customers with suitable protections as contemplated by the SEA?

We request quantified comments where possible.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. *See* FINRA Launches Toll-Free FINRA Securities Helpline for Seniors (Apr. 20, 2015).

4. FINRA notes that Delaware, Missouri and Washington have enacted statutes that permit financial institutions, including broker-dealers, to place temporary holds on "disbursements" or "transactions" if financial exploitation of covered persons is suspected. *See* Del. Code Ann. tit. 31, § 3910 (2015); Mo. Rev. Stat. §§ 409.600-.630 (2015); and Wash. Rev. Code §§ 74.34.215, 220 (2015). Due to the small number of state statutes currently in effect and the lack of a uniform state or federal standard in this area, FINRA believes that the proposed rules would aid in the creation of a uniform national standard for the benefit of firms and their customers.

5. While the proposed amendments do not specify what contact information should be obtained, FINRA believes that a mailing address, phone number and email address for the trusted contact person may be the most useful to firms.

6. FINRA also notes that a customer's request to change his or her trusted contact person may be a possible red flag of financial exploitation (*e.g.*, a senior customer changing his trusted contact person from an immediate family member to a previously unknown third party).

7. With respect to disclosing information to the trusted contact person, FINRA notes that Regulation S-P excepts from the Regulation's notice and opt-out requirements disclosures made: (A) to comply with federal, state, or local laws, rules and other applicable legal requirements; or (B) made with client consent, provided such consent has not been revoked. *See* 17 C.F.R §§ 248.15(a)(1) and (a)(7)(i). FINRA believes that disclosures to a trusted contact person pursuant to proposed Rules 2165 or 4512 or with unrevoked customer consent would be consistent with Regulation S-P.

8. FINRA understands that some firms, pursuant to state law or their own policies, may already place temporary holds on disbursements from customers' accounts where financial exploitation is suspected.

9. *See* National Senior Investor Initiative: A Coordinated Series of Examinations, SEC's Office of Compliance Inspections and Examinations and FINRA (Apr. 15, 2015) (noting the increase in persons aged 65 and older living in the United States and the concentration of wealth in those persons during a time of downward yield pressure on conservative income-producing investments) (hereinafter Senior Investor Initiative). *See also* The MetLife Study of Elder Financial Abuse: Crimes of Occasion, Desperation, and Predation Against America's Elders (June 2011) (noting the many forms of

vulnerability that "make elders more susceptible to [financial]abuse," including, among others, poor physical or mental health, lack of mobility, and isolation); Protecting Elderly Investors from Financial Exploitation: Questions to Consider (Feb. 11, 2015) (noting that one of the greatest risk factors for diminished capacity is age).

10. *See, e.g.*, Aging Statistics, U.S. Department of Health and Human Services Administration on Aging (referring to the "older population" as persons "65 years or older"); Senior Investor Initiative (noting the examinations underlying the report "focused on investors aged 65 years old or older").

11. FINRA notes that a firm may not ignore contrary evidence in making a determination based on the facts and circumstances observed in the firm's business relationship with the natural person (*e.g.*, a court order finding a customer to be legally incompetent).

12. Proposed Rule 2165 would apply only to disbursements of funds or securities from the account of a specified adult and would not apply to transactions in securities.

13. For purposes of proposed Rule 2165, the term "immediate family member" shall include a spouse, child, grandchild, parent, brother or sister, mother-in-law or father-in-law, brother-in-law or sister-in-law, and son-in-law or daughter-in-law, each of whom must be age 18 or older.

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ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

Text of Proposed Changes to FINRA Rule 4512

* * * * *

4000. FINANCIAL AND OPERATIONAL RULES

* * * * *

4500. BOOKS, RECORDS AND REPORTS

* * * * *

4512. Customer Account Information

(a) Each member shall maintain the following information:

(1) for each account:

(A) customer's name and residence;

(B) whether customer is of legal age;

(C) name(s) of the associated person(s), if any, responsible for the account, and if multiple individuals are assigned responsibility for the account, a record indicating the scope of their responsibilities with respect to the account, provided, however, that this requirement shall not apply to an institutional account;

(D) signature of the partner, officer or manager denoting that the account has been accepted in accordance with the member's policies and procedures for acceptance of accounts; [and]

(E) if the customer is a corporation, partnership or other legal entity, the names of any persons authorized to transact business on behalf of the entity; and

(F) subject to Supplementary Material .06, name of and contact information for a trusted contact person who may be contacted about the customer's account, is age 18 or older and not authorized to transact business on behalf of the account; provided, however, that this requirement shall not apply to an institutional account.

(2) through (3) No Change.

(b) A member need not meet the requirements of this Rule with respect to any account that was opened pursuant to a prior FINRA rule until such time as the member updates the information for the account either in the course of the member's routine and customary business or as otherwise required by applicable laws or rules.

(c) No Change.

• • • Supplementary Material: --------------

.01 through .05 No Change.

.06 Trusted Contact Person

(a) With respect to paragraph (a)(1)(F) of this Rule, at the time of account opening, a member shall disclose in writing, which may be electronic, to the customer that the member or an associated person of the member is authorized to contact the trusted contact person and disclose information about the customer's account to confirm the specifics of the customer's current contact information, health status, and the identity of any legal guardian, executor, trustee or holder of a power of attorney, and as otherwise permitted by Rule 2165.

(b) The absence of the name of or contact information for a trusted contact person shall not prevent a member from opening or maintaining an account for a customer, provided that the member makes reasonable efforts to obtain the name of and contact information for a trusted contact person.

Text of Proposed New FINRA Rule

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2000. DUTIES AND CONFLICTS

* * * * *

2100. TRANSACTIONS WITH CUSTOMERS

* * * * *

2165. Financial Exploitation of Specified Adults

(a) Definitions

(1) For purposes of this Rule, the term "Specified Adult" shall mean: (A) a natural person age 65 and older; or (B) a natural person age 18 and older who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests.

(2) For purposes of this Rule, the term "Account" shall include any account of a member for which a Specified Adult has the authority to transact business.

(3) For purposes of this Rule, the term "Qualified Person" shall mean an associated person of a member who serves in a supervisory, compliance or legal capacity that is reasonably related to the Account of the Specified Adult.

(4) For purposes of this Rule, the term "Trusted Contact Person" shall mean the person who may be contacted about the Specified Adult's Account in accordance with Rule 4512.

(5) For purposes of this Rule, the term "immediate family member" shall include a spouse, child, grandchild, parent, brother or sister, mother-in-law or father-in-law, brother-in-law or sister-in-law, and son-in-law or daughter-in-law, each of whom must be age 18 or older.

(6) For purposes of this Rule, the term "financial exploitation" shall include:

(A) the wrongful or unauthorized taking, withholding, appropriation, or use of a Specified Adult's funds or securities; or

(B) any act or omission taken by a person, including through the use of a power of attorney, guardianship, or any other authority regarding a Specified Adult, to:

(i) obtain control, through deception, intimidation or undue influence, over the Specified Adult's money, assets or property; or

(ii) convert the Specified Adult's money, assets or property.

(b) Temporary Hold on Disbursements

(1) A Qualified Person may place a temporary hold on a disbursement of funds or securities from the Account of a Specified Adult if:

(A) The Qualified Person reasonably believes that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted; and

(B) The member not later than two business days provides notification of the temporary hold and the reason for the temporary hold to:

(i) all parties authorized to transact business on the Account; and

(ii) the Trusted Contact Person, unless the Trusted Contact Person is unavailable or the member reasonably believes that the Trusted Contact Person has engaged, is engaged, or will engage in the financial exploitation of the Specified Adult, in which case the member shall attempt to contact an immediate family member of the Specified Adult, if available, unless the member reasonably believes that the immediate family member has engaged, is engaged, or will engage in the financial exploitation of the Specified Adult; and

(C) The member immediately initiates an internal review of the facts and circumstances that caused the Qualified Person to reasonably believe that the financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted.

(2) The temporary hold authorized by this Rule will expire not later than 15 business days after the date that the Qualified Person first placed the temporary hold on the disbursement of funds or securities, unless sooner terminated by an order of a court of competent jurisdiction or extended either by an order of a court of competent jurisdiction or pursuant to paragraph (b)(3) of this Rule.

(3) Provided that the member's internal review of the facts and circumstances under paragraph (b)(1)(C) of this Rule supports the Qualified Person's reasonable belief that the financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted, the temporary hold authorized by this Rule may be extended by a Qualified Person for no longer than 15 business days following the date authorized by paragraph (b)(2) of this Rule, unless sooner terminated by an order of a court of competent jurisdiction.

(c) Record Retention

Members shall retain records related to compliance with this Rule, which shall be readily available to FINRA, upon request. The retained records shall include, but shall not be limited to, records of: (1) request(s) for disbursement that may constitute financial exploitation of a Specified Adult and the resulting temporary hold; (2) the finding of a reasonable belief that financial exploitation has occurred, is occurring, has been attempted, or will be attempted underlying the decision to place a temporary hold on a disbursement; (3) notification(s) to the relevant parties pursuant to paragraph (b)(1)(B) of this Rule; and (4) the internal review of the facts and circumstances pursuant to paragraph (b)(1)(C) of this Rule.

• • • Supplementary Material: --------------

.01 Applicability of Rule. This Rule provides members with a safe harbor when they exercise discretion in placing temporary holds on disbursements of funds or securities from the Account of a Specified Adult under the specified circumstances denoted in the Rule. This Rule does not require members to place temporary holds on disbursements of funds or securities from the Account of a Specified Adult.

.02 Supervision. In addition to the general supervisory and recordkeeping requirements of Rules 3110, 3120, 3130, 3150, and Rule 4510 Series, a member relying on this Rule must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with this Rule, including, but not limited to, procedures related to the identification, escalation and reporting of matters related to financial exploitation of Specified Adults.

.03 Training. A member relying on this Rule must develop and document specific training policies or programs reasonably designed to ensure that registered persons comply with the requirements of this Rule.

.04 Reasonable Belief of Mental or Physical Impairment. A member's reasonable belief that a natural person age 18 and older has a mental or physical impairment that renders the individual unable to protect his or her own interests may be based on the facts and circumstances observed in the member's business relationship with the natural person.

Regulatory Notice 12-55

December 2012

Suitability

Guidance on FINRA's Suitability Rule

Executive Summary

In November 2010, the Securities and Exchange Commission (SEC) approved FINRA Rule 2111 (Suitability), which became effective on July 9, 2012.[1] In May 2012, FINRA issued *Regulatory Notice 12-25*, which provides guidance on the rule in a "frequently asked questions" (FAQ) format.[2] This *Notice* addresses two issues discussed in *Regulatory Notice 12-25*: the scope of the terms "customer" and "investment strategy." In addition, FINRA has created a suitability Web page that, among other things, will locate in one place questions and answers regarding FINRA Rule 2111.

Questions regarding this *Notice* should be directed to:

- James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270; or
- Matthew E. Vitek, Assistant General Counsel, OGC, at (202) 728-8156.

Discussion

FINRA Rule 2111 requires, in part, that a broker-dealer or registered representative "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 customer's investment profile.[3] In *Regulatory Notice 12-25*, FINRA addressed the scope of the terms "customer" and "investment strategy" in FAQ 6, 7 and 10. The answers to those questions are superseded by the answers provided below in this *Notice*.

Financial Industry Regulatory Authority

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topics

- Customer
- Investment Strategies
- Outside Business Activities
- Recommendation
- Suitability
- Supervision

Referenced Rules and Notices

- FINRA Rule 0160
- FINRA Rule 2010
- FINRA Rule 2020
- FINRA Rule 2090
- FINRA Rule 2111
- FINRA Rule 2210
- FINRA Rule 3270
- FINRA Rule 4512
- NASD Rule 2210
- NASD Rule 3010
- NASD Rule 3040
- NTM 05-50
- NTM 04-89
- NTM 04-72
- NTM 01-23
- NTM 99-45
- Regulatory Notice 12-25
- Regulatory Notice 11-25
- Regulatory Notice 11-02
- Regulatory Notice 10-22
- Regulatory Notice 10-06
- Regulatory Notice 08-35
- SEA Rules 17a-3 and 17a-4

Customer

Question 6 from *Regulatory Notice 12-25* is now 6(a) with a new answer

Q6(a). What constitutes a "customer" for purposes of the suitability rule?

A6(a). The suitability rule applies to a broker-dealer's or registered representative's recommendation of a security or investment strategy involving a security to a "customer." FINRA's definition of a customer in FINRA Rule 0160 excludes a "broker or dealer."[4] In general, for purposes of the suitability rule, the term customer includes a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer's affiliate or a custodial agent (*e.g.,* "direct application" business,[5] "investment program" securities,[6] or private placements[7]), or using another similar arrangement.[8]

New question and answer 6(b)

Q6(b). Does the suitability rule apply when a broker-dealer or registered representative makes a recommendation to a potential investor?

A6(b). The suitability rule would apply when a broker-dealer or registered representative makes a recommendation[9] to a *potential investor* who then becomes a customer. Where, for example, a registered representative makes a recommendation to purchase a security to a *potential investor,* the suitability rule would apply to the recommendation if that individual executes the transaction through the broker-dealer with which the registered representative is associated or the broker-dealer receives or will receive, directly or indirectly, compensation as a result of the recommended transaction.[10] In contrast, the suitability rule would not apply to the recommendation in the example above if the *potential investor* does not act on the recommendation or executes the recommended transaction away from the broker-dealer with which the registered representative is associated without the broker-dealer receiving compensation for the transaction.[11]

Investment Strategy

Question 7 from *Regulatory Notice 12-25* with a new answer

Q7. The new suitability rule requires that a recommended investment strategy involving a security or securities must be suitable. Can you provide some examples of what would and would not be considered an "investment strategy" under the rule?

A7. Rule 2111 states that the term "investment strategy" is to be interpreted "broadly."[12] However, FINRA would not consider a broker-dealer's or registered representative's recommendation that a customer generally invest in "equity" or "fixed income" securities to be an investment strategy covered by the rule, unless such a recommendation was part of an asset allocation plan not eligible for the safe-harbor provision in Rule 2111.03 (discussed in FAQ 8).[13] The "investment strategy" language would apply to recommendations to customers to invest in more specific types of securities, such as high dividend companies or the "Dogs of the Dow,"[14] or in a market sector, regardless of whether the recommendations identify *particular* securities.[15] It also would apply to recommendations to customers generally to use a bond ladder, day trading, "liquefied home equity,"[16] or margin strategy involving securities, irrespective of whether the recommendations mention *particular* securities.

In addition, the term would capture an *explicit* recommendation to *hold* a security or securities or to continue to use an investment strategy involving a security or securities.[17] The rule would apply, for example, when a registered representative meets (or otherwise communicates) 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 or to continue to use an investment strategy. However, as explained in FAQ 3, the rule would not cover an implicit recommendation to hold.

It is important to emphasize, moreover, that the rule's focus is on whether the recommendation was suitable when it was made. A recommendation to hold securities, maintain an investment strategy involving securities or use another investment strategy involving securities—as with a recommendation to purchase, sell or exchange securities—normally would not create an ongoing duty to monitor and make subsequent recommendations.

Question 10 from *Regulatory Notice 12-25* is now 10(a) with a new answer

Q10(a). Does the new rule's "investment strategy" language cover a registered representative's recommendation involving both a security and a non-security investment?

A10(a). The new suitability rule would continue to cover a broker-dealer's or registered representative's recommendation of an "investment strategy" involving both a security and a non-security investment.[18] Suitability obligations apply, for example, to a broker-dealer's or registered representative's recommendation of an investment strategy to use home equity to purchase securities[19] or to liquidate securities to purchase an investment-related product that is not a security.[20]

However, where a broker-dealer's or registered representative's recommendation does not refer to a security or securities, the suitability rule is not applicable. The suitability rule would not apply, for instance, if a registered representative recommends a non-security investment as part of an outside business activity and the customer separately decides on his or her own to liquidate securities positions and apply the proceeds toward the recommended non-security investment.[21] Where a customer, absent a recommendation by a registered representative, decides on his or her own to purchase a non-security investment and then asks the registered representative to recommend which securities he or she should sell to fund the purchase of the non-security investment, the suitability rule would apply to the registered representative's recommendation regarding which securities to sell but not to the customer's decision to purchase the non-security investment.

New question and answer 10(b)

Q10(b). What are a broker-dealer's supervisory responsibilities for a registered representative's recommendation of an investment strategy involving both a security and a non-security investment?

A10(b). FINRA's supervision rules do not dictate the exact manner in which a broker-dealer must supervise its registered representatives' recommendations of investment strategies involving a security and a non-security investment. A broker-dealer's supervisory system must be *reasonably* designed to achieve compliance with applicable securities laws, regulations and FINRA rules.[22] The reasonableness of a supervisory system will depend on the facts and circumstances. As FINRA has stated previously, "FINRA appreciates that no two [broker-dealers] are exactly alike. [Broker-dealers] have different business models; offer divergent services, products and investment strategies; and employ distinct approaches to complying with applicable regulatory requirements."[23] A broker-dealer can consider a variety of approaches to identifying and supervising its registered representatives' recommendations of investment strategies involving both a security and a non-security component.

A broker-dealer may use a risk-based approach to supervising its registered representatives' recommendations of investment strategies with both a security and non-security component. For instance, as long as the supervisory system is reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules, a firm could focus on the detection, investigation and follow-up of "red flags" indicating that a registered representative may have recommended an unsuitable investment strategy with both a security and non-security component.[24] A registered representative's recommendation that a customer with limited means purchase a large position in a security might raise a "red flag" regarding the source of funds for such a purchase. Similarly, a registered representative's recommendation that a "buy and hold" customer with an investment objective of income liquidate large positions in blue chip stocks paying regular dividends might raise a "red flag" regarding whether that recommendation is part of a broader investment strategy.

Once a broker-dealer identifies a recommended investment strategy involving both a security and a non-security investment, the broker-dealer's suitability obligations apply to the security component of the recommended strategy[25] but its suitability analysis also must be informed by a general understanding of the non-security component of the recommended investment strategy. In the context of a recommended investment strategy involving a security and an outside business activity, the broker-dealer's general understanding of the outside business activity would be based on the information and considerations required by FINRA Rule 3270.[26]

Finally, broker-dealers must keep in mind that, in addition to suitability and supervisory responsibilities, firms have other regulatory obligations to investigate unusual activity.

Endnotes

1. *See* 75 Fed. Reg. 71479 (Nov. 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039); *Regulatory Notice 11-25*. In addition, the SEC's order approved FINRA Rule 2090 (Know Your Customer), which also became effective on July 9, 2012. *Id.*
2. For purposes of this *Notice,* a reference to a numbered FAQ means the FAQ from *Regulatory Notice 12-25.*
3. FINRA Rule 2111(a).
4. *See* FINRA Rule 0160(b)(4) (Definition of Customer).
5. *See Notice to Members 04-72*, at 846 ("The BD of record refers to the broker-dealer identified on a customer's account application for accounts held directly at a mutual fund or variable insurance product issuer. Accounts held in this manner are sometimes referred to as 'check and application,' 'application way,' or 'direct application' . . . business.").
6. *Regulatory Notice 08-35*, at 2 (stating that direct participation programs (DPPs) and unlisted real estate investment trusts (REITs) are referred to as "investment programs").
7. *Regulatory Notice 10-22* (discussing broker-dealer obligations for certain private placements).
8. Nothing in this guidance shall be construed as altering a broker-dealer's obligations under applicable federal laws, regulations and rules or other FINRA rules, including, but not limited to, Sections 9, 10(b) and 15(c) of the Securities Exchange Act of 1934, Section 17(a) of the Securities Act of 1933, the Bank Secrecy Act, 31 U.S.C. §§ 5311, *et seq.* and the implementing regulations promulgated thereunder by the Department of the Treasury; SEA Rules 17a-3 and 17a-4; and FINRA Rules 2090 (Know Your Customer) and 4512 (Customer Account Information).
9. FINRA reiterates that the suitability rule applies only if a broker-dealer or registered representative makes a "recommendation." FINRA previously has provided guiding principles that firms and registered representatives could consider when determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule. *See, e.g.,* FAQ 2 (discussing the term "recommendation" and citing various resources that explain the guiding principles that firms could use when analyzing whether a communication constitutes a recommendation); *Regulatory Notice 11-02*, at 2-3 (discussing FINRA's guiding principles); *Regulatory Notice 10-06*, at 3-4 (providing guidance on recommendations made on blogs and social networking websites); *Notice to Members 01-23* (announcing the guiding principles and providing examples of communications that likely do and do not constitute recommendations); *Michael F. Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *21-27 (Oct. 6, 2008) (applying the guiding principles to the facts of the case to find a recommendation), *aff'd in relevant part,* 592 F.3d 147 (D.C. Cir.), *cert. denied,* 130 S.Ct. 3333 (2010).
10. In the example above regarding a recommendation to a *potential investor,* suitability obligations attach when the transaction occurs, but the suitability of the recommendation is evaluated based on the circumstances that existed at the time the recommendation was made. However, when a broker-dealer or registered representative makes a recommendation to a *customer* (as opposed

to a *potential investor*), suitability obligations attach at the time the recommendation is made, irrespective of whether a transaction occurs. *See* *Regulatory Notice 11-25*, at 6; *Regulatory Notice 11-02*, at 3.

11. Depending on the facts and circumstances, a registered representative's recommendation to a potential investor also could raise concerns under, among other rules, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices); Rule 2210 (Communications with the Public); and NASD Rule 3040 (Private Securities Transactions of an Associated Person); *see also Dep't of Enforcement v. Salazar,* No. 20100224056, 2012 FINRA Discip. LEXIS 22 (Mar. 12, 2012) (finding that registered representative violated NASD Rules 2310 and 3040 when he recommended unsuitable private securities transactions to investors who were not his firm's customers, received compensation in relation to the transactions and failed to notify his firm of such activity); *Maximo J. Guevara,* 54 S.E.C. 655, 2000 SEC LEXIS 986 (2000) (holding that registered representative violated NASD Rules 2310 and 3040 where he recommended unsuitable securities that were sold away from the firm with which he was associated without providing his firm prior notice of such activities).

12. *See* FINRA Rule 2111.03.

13. *See id.* As described in greater detail in FAQ 8, there is a safe harbor for certain types of educational information and asset allocation models that otherwise could be considered investment strategies captured by the new rule.

14. The "Dogs of the Dow" strategy is premised on investing "equal dollar amounts in the ten constituents of the Dow Jones industrial average with the highest dividend yields, hold[ing] them for twelve months and then switch[ing] to a new group of dogs." Vincent Apicella, *Stock Focus: "Dogs of the Dow" Companies,* Forbes.com (May 29, 2001).

15. The rule would apply, for instance, to a registered representative's recommendation to a customer to purchase shares of high dividend companies even though the registered representative does not mention a *particular* high dividend company.

16. *See* *Notice to Members 04-89* (discussing liquefied home equity).

17. *See* FINRA Rule 2111.03.

18. While the suitability rule applies only to recommendations involving a security or securities, other FINRA rules potentially apply, depending on the facts of the particular case, to broker-dealers' or registered representatives' conduct that does not involve securities. *See, e.g.,* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 3270 (Outside Business Activities of Registered Persons); Rule 2210 (Communications with the Public); *see also Ialeggio v. SEC,* No. 98-70854, 1999 U.S. App. LEXIS 10362, *4-5 (9th Cir. May 20, 1999) (holding that FINRA's requirement that registered representatives act in a manner consistent with just and equitable principles of trade applies to all unethical business conduct, regardless of whether the conduct involves securities); *Vail v. SEC,* 101 F.3d 37, 39 (5th Cir. 1996) (same); *Robert L. Wallace,* 53 S.E.C. 989, 995, 1998 SEC LEXIS 2437, at *13 (1998) (emphasizing, in an action involving viatical settlements, that Rule 2210 is "not limited to advertisements for securities, but provide[s] standards applicable to all [broker-dealer] communications with the public").

19. FINRA made similar points regarding recommended investment strategies on several occasions under the predecessor suitability rule. FINRA explained in one instance under the predecessor rule that "recommending liquefying home equity to purchase securities may not be suitable for all investors. [Broker-dealers or registered representatives] should consider not only whether the recommended investments are suitable, but also whether the strategy of investing liquefied home equity in securities is suitable." *Notice to Members 04-89*, at 3. *See also Donna M. Vogt,* AWC No. EAF0400730002 (Feb. 21, 2007) (barring registered representative for, among other things, recommending to ten customers, many of whom were nearing retirement, that they obtain home equity loans and use the proceeds to purchase securities, without considering whether such recommendations were suitable for such customers in light of their financial situation and needs); *James A. Kenas,* AWC No. C3B040001 (Jan. 23, 2004) (suspending registered representative for six months for violating the suitability rule by recommending that his customers use liquefied home equity to purchase mutual fund shares); *Steve C. Morgan,* AWC No. C3A040016 (Mar. 9, 2004) (suspending registered representative for six months and ordering him to pay restitution of more than $15,000 for recommending that a retired couple use liquefied home equity to purchase a variable annuity).

20. *See Notice to Members 05-50*, at 5 ("[R]ecommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender[s] are for the purpose of funding the purchase of an unregistered [equity indexed annuity].").

21. FINRA Rule 3270.01 (Outside Business Activities of Registered Persons) requires a broker-dealer, upon receipt of a registered person's written notice of a proposed outside business activity, to consider whether the proposed activity will "interfere with or otherwise compromise the registered person's responsibilities to the [broker-dealer or the broker-dealer's] customers or be viewed by customers or the public as part of the [broker-dealer's] business. . . ." *Id.* In addition, the broker-dealer "must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including[,] where circumstances warrant, prohibiting the activity." *Id.* A broker-dealer "also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirement of NASD Rule 3040" (Private Securities Transactions of an Associated Person). *Id.* Furthermore, a broker-dealer "must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1)." *Id.*

22. *See* NASD Rule 3010 (Supervision).

23. *Regulatory Notice 12-25*, at 2.

24. In *Notice to Members 99-45*, FINRA said that the supervision rule "requires that a [firm's] supervisory system be reasonably designed to achieve compliance with applicable laws and regulations. This standard recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations. However, this standard does require that the system be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business." *Id.* at 295.

25. For example, in supervising an identified recommended investment strategy involving a security and a non-security component, a broker-dealer may need to consider, in addition to the customer's investment profile, whether a recommended securities liquidation causes an overconcentration in particular securities or types of securities remaining in the account, changes the composition of the customer's remaining securities investments to an extent that the customer's portfolio no longer matches his or her investment profile, subjects the customer to early withdrawal fees or penalties, exposes the customer to losses because of the lack of a ready market for the securities at the time of the liquidation, or results in potential adverse tax treatment.

26. *See also supra* note 21 and discussion therein.

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Regulatory Notice 12-25

Suitability

Additional Guidance on FINRA's New Suitability Rule

Implementation Date: July 9, 2012

Executive Summary

In November 2010, the Securities and Exchange Commission (SEC) approved FINRA's new suitability rule, FINRA Rule 2111.[1] FINRA then issued *Regulatory Notice 11-02*, which announced the SEC's approval of the new rule and discussed its requirements. FINRA also issued *Regulatory Notice 11-25*, which offered further guidance on the rule and announced a new implementation date of July 9, 2012. This *Notice* provides additional guidance on the rule in response to recent industry questions.

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.

Discussion

New FINRA Rule 2111 requires, in part, that a broker-dealer 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 [firm] or associated person to ascertain the customer's investment profile."[2] In general, FINRA's new suitability rule retains the core features of the previous NASD suitability rule, NASD Rule 2310. In addition, Rule 2111 codifies several important interpretations of the predecessor rule and imposes a few new or modified obligations.

The new rule, for instance, codifies and clarifies the three main suitability obligations that previously had been discussed largely in case law:

- reasonable-basis suitability (a broker must perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and determine whether the recommendation is suitable for at least *some* investors based on that understanding);

May 2012

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topics

- Acting in Customers' Best Interests
- Complex Securities
- Customer
- Information Gathering
- Institutional-Customer Exemption
- Investment Strategies
- Reasonable Diligence
- Recommendation
- Risk-Based Compliance
- Suitability

Referenced Rules and Notices

- Bank Secrecy Act
- FINRA Rules 0160, 1250, 2010, 2020, 2090, 2111, 2210, 2214, 2330, 2360, 2370, 3270, 4512 and 5310
- JOBS Act
- NASD Rules 1014, 1021, 1031, 2210, 2310 and 3010
- NTMs 05-59, 05-50, 05-26, 05-18, 04-89, 04-30, 03-71, 03-07, 01-23, 99-45, 96-32 and 93-73
- Regulatory Notices 12-03, 11-25, 11-15, 11-02, 10-51, 10-22, 10-09, 10-06, 09-73, 09-31 and 08-81
- Rule 506 of Regulation D
- SEA Rules 17a-3 and 17a-4

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- customer-specific suitability (a broker must have a reasonable basis to believe that a recommendation of a security or investment strategy involving a security or securities is suitable for the particular customer based on the customer's investment profile); and
- quantitative suitability (a broker who has control over a customer account must have a reasonable basis to believe that a series of recommended securities transactions are not excessive).

The new rule also broadens the explicit list of customer-specific factors that firms and associated persons generally must attempt to obtain and analyze when making recommendations to customers.[3] The new rule adds a customer's age, investment experience,[4] time horizon,[5] liquidity needs[6] and risk tolerance[7] to the explicit list of customer-specific factors from the predecessor rule (*i.e.*, other investments,[8] financial situation and needs,[9] tax status,[10] and investment objectives[11]). These factors generally make up a customer's investment profile.

The new rule, moreover, imposes broader obligations on firms and associated persons regarding recommendations of investment strategies involving a security or securities. Not only does the new rule now explicitly cover recommended investment strategies involving a security or securities, but it also states that the term "investment strategy" is to be interpreted "broadly" and includes recommendations to "hold" a security or securities. In addition, the new rule modifies the institutional-customer exemption by changing the definition of institutional customer and requiring an affirmative indication from the institutional customer of its intention to independently analyze the broker-dealer's recommendations. Finally, FINRA stated that firms generally may use a risk-based approach to documenting compliance with the rule.[12]

Soon after the SEC approved Rule 2111, broker-dealers began assessing the extent to which they needed to prepare new or update current procedures, modify automated systems and educate their associated persons regarding compliance with the new rule. In the *Regulatory Notices* referenced above, FINRA addressed numerous issues that firms initially raised. Firms, however, have asked FINRA for additional guidance regarding issues they subsequently identified while developing their approaches to complying with the new rule. This *Notice* provides answers to those questions.

FINRA reiterates, however, that many of the obligations under the new rule are the same as those under the predecessor rule and related case law. Existing guidance and interpretations regarding suitability obligations continue to apply to the extent that they are not inconsistent with the new rule. Furthermore, FINRA appreciates that no two firms are exactly alike. Firms have different business models; offer divergent services, products and investment strategies; and employ distinct approaches to complying with applicable regulatory requirements. FINRA's guidance is not intended to influence any firm's choice of a particular business model or reasonable approach to ensuring compliance with suitability or other regulatory requirements.

Suitability Questions and Answers

Firms' recent questions regarding Rule 2111 have focused on the following topics: the obligation to act in a customer's best interests; the scope of the terms "recommendation," "customer" and "investment strategy"; the use of a risk-based approach to documenting suitability; information-gathering requirements; reasonable-basis and quantitative suitability; and the institutional-customer exemption. The questions addressed below are representative of the issues firms are attempting to resolve as they finalize their compliance strategies. FINRA emphasizes, however, that it previously addressed numerous issues during the rulemaking process and immediately after the SEC approved the rule. FINRA encourages firms to review its responses to comments[13] and *Regulatory Notices 11-02* and *11-25*, which provide additional information regarding the rule's requirements.

Acting in a Customer's Best Interests

Q1. *Regulatory Notice 11-02* and a recent SEC staff study on investment adviser and broker-dealer sales-practice obligations cite cases holding that brokers' recommendations must be consistent with their customers' "best interests."[14] What does it mean to act in a customer's best interests?

A1. In interpreting FINRA's suitability rule, numerous cases explicitly state that "a broker's recommendations must be consistent with his customers' best interests."[15] The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests.[16] Examples of instances where FINRA and the SEC have found brokers in violation of the suitability rule by placing their interests ahead of customers' interests include the following:

- A broker whose motivation for recommending one product over another was to receive larger commissions.[17]
- A broker whose mutual fund recommendations were "designed 'to maximize his commissions rather than to establish an appropriate portfolio' for his customers."[18]
- A broker who recommended "that his customers purchase promissory notes to give him money to use in his business."[19]
- A broker who sought to increase his commissions by recommending that customers use margin so that they could purchase larger numbers of securities.[20]
- A broker who recommended new issues being pushed by his firm so that he could keep his job.[21]
- A broker who recommended speculative securities that paid high commissions because he felt pressured by his firm to sell the securities.[22]

The requirement that a broker's recommendation must be consistent with the customer's best interests does not obligate a broker to recommend the "least expensive" security or investment strategy (however "least expensive" may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests. Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers' interests involved cost-related issues. The cost associated with a recommendation, however, ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.

The customer's investment profile, for example, is critical to the assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. These are all important considerations in analyzing the suitability of a particular recommendation, which is why the suitability rule and the concept that a broker's recommendation must be consistent with the customer's best interests are inextricably intertwined.[23]

Recommendation

Q2. The suitability rule applies only to recommended securities and investment strategies involving securities, but FINRA does not define the term "recommendation" other than to say that it is a facts and circumstances inquiry. What factors determine whether a recommendation has been made for purposes of the suitability rule?

A2. Although FINRA does not define the term "recommendation," it has offered several guiding principles that firms and brokers should consider when determining whether particular communications could be viewed as recommendations. FINRA has extensively addressed those guiding principles in past *Regulatory Notices*, and cases have applied them to specific facts.[24] Some SEC releases and FINRA cases and interpretive letters also have explained that a broker-dealer's use or distribution of marketing or offering materials ordinarily would not, by itself, constitute a "recommendation" for purposes of the suitability rule.[25] The prior guidance and interpretations generally remain applicable,[26] and firms and brokers should review those existing resources for assistance in understanding the breadth of the term "recommendation."

Q3. FINRA has stated that the new suitability rule does not broaden the scope of implicit recommendations applicable to the predecessor rule. What are the conditions under which an implicit recommendation can trigger the suitability rule?

A3. FINRA and the SEC have recognized that certain actions constitute implicit recommendations that can trigger suitability obligations. FINRA and the SEC have held, for example, that brokers who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule.[27] 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, for example, does not apply to *implicit* recommendations to *hold* a security or securities. Thus, the new rule's "hold" language would not apply when a broker remains silent regarding security positions in an account. The hold recommendation must be explicit.[28]

Q4. Customers sometimes ask broker-dealer call centers whether they may continue to maintain their investments at the firm if, for instance, they want to move from an employer-sponsored retirement account held at the firm to an individual retirement account held at the firm. If a firm's call center informs customers that they are permitted to continue to maintain their investments at the firm under such circumstances, would FINRA consider those communications to be "hold" recommendations triggering application of the new suitability rule?

A4. In general, FINRA would not view those communications as "hold" recommendations for purposes of the rule because the firm's call center is not responding to the question of whether the customer should hold the securities, but rather whether the customer can continue to maintain them at the firm.

Q5. Section 201(a) of the Jumpstart Our Business Startups Act (JOBS Act)[29] directs the SEC to amend Rule 506 of Regulation D under the Securities Act of 1933 to eliminate the prohibition on general solicitations to the extent that all purchasers are accredited investors. Does the elimination of the general solicitation prohibition mean that broker-dealers no longer have suitability obligations regarding private placements?

A5. No. The JOBS Act removes certain marketing impediments but not a broker-dealer's suitability obligations. In that regard, and as explained above in the answer to question 2, a broker-dealer's general solicitation of a private placement through the use or distribution of marketing or offering materials ordinarily would not, by itself, constitute a recommendation triggering application of the suitability rule.[30] When a broker-dealer "recommends" a private placement, however, the suitability rule applies.[31]

Customer

Q6. What constitutes a "customer" for purposes of the suitability rule?

A6. The suitability rule only applies to a broker's recommendation to a "customer." FINRA defines "customer" broadly as including anyone who is not a "broker or dealer."[32] Although in certain circumstances the term may include some additional parameters, a "customer" clearly would include an individual or entity with whom a broker-dealer has even an *informal* business relationship related to brokerage services, as long as that individual or entity is not a broker or dealer. A broker-customer relationship would arise and the suitability rule would apply, for example, when a broker recommends a security to a *potential* investor, even if that potential investor does not have an account at the firm.

Investment Strategy

Q7. The new suitability rule requires that a recommended investment strategy involving a security or securities must be suitable. What is an "investment strategy" under the rule?

A7. Rule 2111 states that the term "investment strategy" is to be interpreted "broadly."[33] The new rule would cover a recommended investment strategy involving a security or securities regardless of whether the recommendation results in a securities transaction or even mentions a specific security or securities.[34] FINRA would not consider a broker's recommendation that a customer generally invest in equities or fixed-income securities to be an investment strategy covered by the rule, unless such a recommendation was part of an asset allocation plan not eligible for the safe-harbor provision in Rule 2111.03 (discussed below in the answer to question 8). The rule would, however, apply to recommendations to invest in more specific types of securities, such as high dividend companies or the "Dogs of the Dow,"[35] or in a particular market sector. It also would apply to recommendations generally to use a bond ladder, day trading, "liquefied home equity,"[36] or margin strategy involving securities, irrespective of whether the recommendations mention particular securities.

Additionally, the term would capture an *explicit* recommendation to *hold* a security or securities or to continue to use an investment strategy involving a security or securities.[37] 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 or to continue to use an investment strategy. However, as explained above in the answer to question 3, the rule would not cover an implicit recommendation to hold.

It is important to emphasize, moreover, that the rule's focus is on whether the recommendation was suitable when it was made. A recommendation to hold securities, maintain an investment strategy involving securities, or use another investment strategy involving securities—as with a recommendation to purchase, sell or exchange securities—normally would not create an ongoing duty to monitor and make subsequent recommendations.

Q8. What is the scope of the safe-harbor provision in Rule 2111.03 regarding a firm's use of an asset allocation model?

A8. Rule 2111.03 excludes from the suitability rule's coverage various types of communications that are educational in nature even though they could be considered investment strategies involving securities. The rule states that certain communications "are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities[.]"[38] Specifically, the rule provides a safe harbor for firms' use of "[a]sset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with NASD IM-2210-6 (Requirements for the Use of Investment Analysis Tools) (soon to be renumbered as FINRA Rule 2214), if the asset allocation model is an 'investment analysis tool' covered by [the interpretative material]."[39]

Under this provision, the suitability rule would not apply, for example, to a general recommendation that a customer's portfolio have certain percentages of investments in equity securities, fixed-income securities and cash equivalents, if the recommendation is based on an asset allocation model that meets the above criteria and the firm does not recommend a particular security or securities in connection with the allocation. The suitability rule also would not apply to a firm's allocation recommendation regarding broad-based market sectors (*e.g.*, agriculture, construction, finance, manufacturing, mining, retail, services, transportation and public utilities, and wholesale trade).[40] Again, however, the recommendation must be based on an asset allocation model that meets the above criteria and cannot include recommendations of particular securities.

In this regard, firms should note that, as an allocation recommendation becomes narrower or more specific, the recommendation gets closer to becoming a recommendation of particular securities and, thus, subject to the suitability rule, depending on a variety of factors (including the number of issuers that fall within the broker-dealer's allocation recommendation).[41] Accordingly, broker-dealers should assess whether allocation recommendations involving certain types of sub-categories of broader market sectors or even more limited groupings are so specific or narrow that they constitute recommendations of particular securities.[42]

Q9. Would a recommendation to maintain an asset mix that was based on an asset allocation model that meets the criteria described in the rule fall within the safe-harbor provision in Rule 2111.03?

A9. Yes. The safe-harbor provision in Rule 2111.03 would apply to a recommendation to maintain a generic asset mix based on an asset allocation model that meets the criteria described in the rule if the firm does not explicitly recommend that the customer "hold" the specific securities that make up the allocation.

Q10. Does the new rule's "investment strategy" language cover a broker's recommendation involving both a security and a non-security investment?

A10. Yes. Just as *Regulatory Notices* and disciplinary actions make clear under the predecessor rule, the new suitability rule would continue to cover a broker's recommendation of an "investment strategy" involving both a security and a non-security.[43] Suitability obligations apply, for example, to a broker's recommendation of an investment strategy to use home equity to purchase securities[44] or to liquidate securities to purchase an investment-related product that is not a security.[45]

Some firms have raised questions regarding their supervisory responsibilities for such recommendations. A firm's supervisory system must be *reasonably* designed to achieve compliance with applicable securities laws and regulations and FINRA rules.[46] Although the reasonableness of a supervisory system will depend on the facts and circumstances, a firm may use a risk-based approach to supervising its brokers' recommendations of investment strategies with both a security and non-security component. For instance, as long as the supervisory system is reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules, a firm could focus on the detection, investigation and follow-up of "red flags" indicating that a broker may have recommended an unsuitable investment strategy with both a security and non-security component.[47] A broker's recommendation that a customer with limited means purchase a large position in a security might raise a "red flag" regarding the source of funds for such a purchase. Similarly, a broker's recommendation that a "buy and hold" customer with an investment objective of income liquidate large positions in blue chip stocks paying regular dividends might raise a "red flag" regarding whether that recommendation is part of a broader investment strategy.

Q11. Does the new rule cover a "hold" recommendation regarding securities that the broker did not originally recommend? Would a broker, for example, be responsible for a hold recommendation involving blue chip stocks that a customer transferred into an account at the broker-dealer?

A11. Where a broker did not recommend the original purchase of a security but *explicitly* recommends that the customer subsequently hold that security, the new suitability rule would apply. However, as stated above and discussed in greater detail below, a

firm may take a risk-based approach to evidencing compliance with the rule. A hold recommendation involving shares of a blue chip stock ordinarily would not present the type of risk, absent unusual facts, that would require a detailed analysis or documentation. Where the hold recommendation involves an overly concentrated position in a security, however, documentation usually would be necessary, even if the broker did not originally recommend the purchase of the security.

Risk-Based Approach to Documenting Compliance With Suitability Obligations

Q12. For purposes of using a risk-based approach to documenting compliance with suitability obligations, what types of recommendations does FINRA generally consider complex or potentially risky?

A12. As with many obligations under various rules, a firm will need to make some judgment calls on the types of recommendations that it should document under FINRA's suitability rule. FINRA previously stated that, although a firm has a general obligation to evidence compliance with applicable FINRA rules, the suitability rule does not include explicit documentation requirements, except in a situation where a firm determines not to seek certain customer information in the first place.[48] The suitability rule applies to *all* recommendations of a security or securities or investment strategies involving a security or securities, but the extent to which a firm needs to document its suitability analysis depends on an assessment of the customer's investment profile and the complexity of the recommended security or investment strategy involving a security or securities (in terms of both its structure and potential performance) and/or the risks involved.[49]

The recommendation of a large-cap, value-oriented equity security usually would not require documentation. Conversely, the recommendation of a complex and/or potentially risky security or investment strategy involving a security or securities usually would require documentation. Numerous *Regulatory Notices* and cases discuss various types of complex and/or potentially risky securities and investment strategies involving a security or securities. Firms and brokers may want to consult those *Regulatory Notices*[50] and cases[51] when considering the types of recommended securities and investment strategies involving securities that they should document.

Q13. What types of "hold" recommendations should firms consider documenting?

A13. For "hold" recommendations, FINRA has stated that a firm may want to focus on 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 a product's character over time; that are particularly susceptible to changes in market conditions; or that are otherwise potentially risky or problematic to hold at the time the recommendations are made.[52]

Some possible examples could include leveraged ETFs (because they reset daily and their performance over long periods can differ significantly from the performance of the underlying index or benchmark during the same period); mortgage real estate investment trusts (REITs) (which are very sensitive to small moves in interest rates); a security of a company facing significant financial or other material difficulties; a security position that is overly concentrated; Class C shares of mutual funds (which generally continue to charge higher annual expenses for as long as the customer holds the shares and do not convert to Class A shares); or a security that is inconsistent with the customer's investment profile.

Q14. How should a firm document "hold" recommendations?

A14. The suitability rule does not prescribe the manner in which a firm must document "hold" recommendations when documentation may be necessary. Some firms may create "hold" tickets and some may add "hold" sections to existing order tickets. Other firms may require emails or memoranda to supervisors or emails or letters to customers copying supervisors. Still other firms may create data fields for entering such information into automated supervisory systems.

These are only examples of how some firms may document "hold" recommendations if necessary. Firms do not have to document or individually approve every "hold" recommendation.[53] As with recommendations of other types of investment strategies or of purchases, sales or exchanges of securities, firms may use a risk-based approach to documenting and supervising "hold" recommendations. FINRA emphasizes, moreover, that firms may use methods that are not highlighted in this *Notice* to document and supervise "hold" recommendations as long as those methods are reasonable.

Information-Gathering Requirements

Q15. Does a broker-dealer have to seek to obtain all of the customer-specific factors listed in the new rule by the rule's implementation date?

A15. No. The rule generally requires a broker-dealer to seek to obtain and analyze the customer-specific factors listed in the rule when making a recommendation to a customer. Accordingly, a broker-dealer could choose to seek to obtain and analyze the customer-specific factors listed in Rule 2111 when it makes new recommendations to customers (regardless of whether they are new or existing customers).[54]

Q16. What constitutes "reasonable diligence" in attempting to obtain the customer-specific information?

A16. Although the reasonableness of the effort will depend on the facts and circumstances, asking a customer for the information ordinarily will suffice. Moreover, absent "red flags" indicating that such information is inaccurate or that the customer is unclear about the information, a broker generally may rely on the customer's responses. A broker may not be able to rely exclusively on a customer's responses in situations such as the following:

- the broker poses questions that are confusing or misleading to a degree that the information-gathering process is tainted,
- the customer exhibits clear signs of diminished capacity, or
- other "red flags" exist indicating that the customer information may be inaccurate.

Q17. What if a customer refuses to provide certain customer-specific information?

A17. Some customers may be reluctant to provide certain types of information to their broker-dealers. A customer, for example, may not want to divulge information about "other investments" held away from the broker-dealer in question. The suitability rule generally requires broker-dealers to use reasonable diligence to seek to obtain and analyze the customer-specific factors listed in the rule. A broker-dealer cannot make assumptions about customer-specific factors for which the customer declines to provide information.[55] Furthermore, when customer information is unavailable despite a broker-dealer's reasonable diligence, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of a recommendation.[56] As with the predecessor rule, however, the new rule would not prohibit a broker-dealer from making a recommendation in the absence of certain customer-specific factors as long as the firm has enough information about the customer to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information will depend on the facts and circumstances of the particular case.[57]

Q18. In addition to using reasonable diligence to obtain and analyze certain *specific* factors about the customer, the new suitability rule requires a broker to consider "any other information the customer may disclose" in connection with the recommendation. How much of a duty does a firm have to pursue "any other information the customer may disclose" to see if it has suitability implications? Does the firm have a duty, for example, to ask its customers if there is anything else it should know about them when collecting information for suitability purposes?

A18. Where a customer discloses information to a broker in connection with the recommendation, the broker must consider that information as part of the suitability analysis. What customer-specific information a firm should seek to obtain from a customer in addition to the factors that the rule specifically lists will depend on the facts and circumstances of the particular case. Although a firm is not required to affirmatively ask customers if there is anything else it should know about them, the better practice is to attempt to gain as much relevant information as possible before making recommendations.

Q19. What is a firm's responsibility when customers indicate that they have multiple investment objectives that appear inconsistent?

A19. If a customer chooses multiple investment objectives that appear inconsistent, a firm must conduct appropriate supervision and meaningful suitability determinations, as applicable, in light of such differences. For example, a firm should, among other things, clarify the customer's intent and, if necessary, reconcile and/or determine how it will handle the customer's differing investment objectives.

Q20. Should the investment experience of a guardian, custodian, trustee or similarly situated third party managing an account be taken into consideration when making account recommendations?

A20. In many circumstances, the answer is yes. In the case of a trust held in a brokerage account, for instance, the firm should consider the trustee's investment experience with, and knowledge of, various investments and investment strategies. The firm, however, also must consider factors such as the trust's investment objectives, time horizon and risk tolerance to complete the suitability analysis.

It also is important to note that, where an *institutional* customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, Rule 2111(b) makes clear that the factors relevant to determining whether the customer meets the criteria for the institutional-customer exemption will be applied to the agent.

Q21. Can a broker make recommendations based on a customer's overall portfolio, including investments held at other financial institutions? For instance, does each individual recommendation have to be consistent with the customer's investment profile or can the suitability of a broker's recommendation be judged in light of its consistency with the customer's overall portfolio?

A21. The answer depends on the facts and circumstances of the particular case. The suitability rule applies on a recommendation-by-recommendation basis. A suitability analysis of a particular recommendation and consideration of a customer's overall investment portfolio, however, are not mutually exclusive concepts. The new suitability rule (as with the predecessor rule) requires a broker to seek to obtain and analyze a customer's other investments. The rule thus explicitly permits a suitability analysis to be performed within the context of a customer's other investments. Some customers, moreover, desire portfolios made up of securities with different levels of liquidity, risk and time horizons. When a broker is aware of a customer's overall portfolio (including investments held at other financial institutions), the broker is permitted to make recommendations based on the customer's overall portfolio as long as the customer is in agreement with such an approach. Under these circumstances, the suitability of a broker's recommendation may be analyzed on the basis of whether the customer's overall portfolio, considering any changes to the portfolio that flow from the broker's recommendation, aligns with the customer's investment profile.[58]

As noted above in the answer to question 17, however, a broker cannot make assumptions about a customer's other holdings.[59] The firm should evidence a customer's approval of a broker's use of a portfolio-based analysis regarding the suitability of the broker's recommendations.[60] Some customers, for instance, may desire all recommendations to be consistent with their stated risk tolerance, investment time horizon or liquidity needs. Accordingly, a broker may not use a portfolio approach to analyzing the suitability of specific recommendations when:

- the customer wants each individual recommendation to be consistent with his or her investment profile or particular factors within that profile;
- the broker is unaware of the customer's overall portfolio; or
- "red flags" exist indicating that a broker's information about the customer's other holdings may be inaccurate.

Nothing in this guidance, moreover, relieves a firm from having to ensure that a customer's investment profile or factors within that profile accurately reflect the customer's decisions.

Reasonable-Basis Suitability

Q22. Can a broker who does not understand the risks associated with a recommendation violate the reasonable-basis obligation even if the recommendation is suitable for *some* investors?

A22. Yes. The reasonable-basis obligation has two components: a broker must (1) perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and (2) determine whether the recommendation is suitable for at least *some* investors based on that understanding.[61] A broker must adhere to both components of reasonable-basis suitability. A broker could violate the obligation if he or she did not understand the recommended security or investment strategy, even if the security or investment strategy is suitable for at least *some* investors. A broker must understand the securities and investment strategies involving a security or securities that he or she recommends to customers.[62]

The reasonable-basis obligation is critically important because, in recent years, securities and investment strategies that brokers recommend to customers, including retail investors, have become increasingly complex and, in some cases, risky. Brokers cannot fulfill their suitability responsibilities to customers (including both their reasonable-basis and customer-specific obligations) when they fail to understand the securities and investment strategies they recommend. Firms' supervisory policies and procedures must be reasonably designed to ensure that their brokers comply with this important requirement.[63]

Quantitative Suitability

Q23. Is the quantitative suitability obligation under the new rule any different from the excessive trading line of cases under the predecessor rule?

A23. No. The quantitative suitability obligation under the new rule simply codifies excessive trading cases. Quantitative suitability requires a broker who has actual or *de facto* control[64] over a customer account to have a reasonable basis for believing that, in light of the customer's investment profile, a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer.[65] Factors such as turnover rate,[66] cost-to-equity ratio,[67] and use of in-and-out trading[68] in a customer's account may provide a basis for finding that the activity at issue was excessive.

Institutional-Customer Exemption

Q24. Some third-party vendors have created "Institutional Suitability Certificates" to facilitate firms' compliance with the new institutional-customer exemption in Rule 2111(b). Has FINRA endorsed or approved any of these certificates?

A24. No. By way of background, the new suitability rule modifies the institutional-customer exemption that existed under the predecessor rule (NASD IM-2310-3). Rule 2111(b) replaces the previous rule's definition of "institutional customer" with the more common definition of "institutional account" in FINRA's "books and records" rule, Rule 4512(c).[69] "Institutional account" means the account of a bank, savings and loan association, insurance company, registered investment company, registered investment adviser or any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.[70] In regard to the "other person" category, the monetary threshold generally changed from at least $10 million invested in securities and/or under management used in the predecessor rule to at least $50 million in assets in the new rule.[71] Moreover, the definition now includes natural persons who meet such criteria.

In addition to the definitional change, the new institutional-customer exemption focuses on two factors: (1) whether a broker "has a reasonable basis to believe the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities" (a factor used in the predecessor rule), and (2) whether "the institutional customer affirmatively indicates that it is exercising independent judgment" (a new requirement).[72] A broker-dealer fulfills its customer-specific suitability obligation if all of these conditions are satisfied.[73]

Some third-party vendors have created and aggressively marketed proprietary "Institutional Suitability Certificates" to facilitate compliance with the new institutional-customer exemption. FINRA has *not* approved or endorsed any third-party Institutional Suitability Certificates and has *not* contracted with any third-party vendor to create such certificates on FINRA's behalf. FINRA also emphasizes that broker-dealers are not required to use such certificates to comply with the new institutional-customer exemption. As discussed below in the answer to question 26, firms can use any number of approaches to complying with the new exemption requirements.

Q25. Some of the "Institutional Suitability Certificates" that are being marketed do not identify an institutional customer's experience with particular asset classes or types of securities or investment strategies involving a security or securities. Does FINRA expect broker-dealers or institutional customers to provide more specificity?

A25. Firms should understand that the use of any such Institutional Suitability Certificate in no way constitutes a safe harbor from the rule. As noted above in the answer to question 24, FINRA has not endorsed or promoted any certificate. What further action a broker-dealer will need to take will depend on the facts and circumstances of the particular case. In general, however, when there is an indication that the institutional customer is not capable of analyzing, or does not intend to exercise independent judgment regarding, *all* of a broker-dealer's recommendations, the broker-dealer necessarily will have to be more specific in its approach to ensuring that it complies with the exemption. A broker-dealer need not automatically use a detailed approach when no such indication exists, although providing at least some level of specificity (even if not required) may help eliminate misunderstandings.

FINRA previously issued written guidance on a customer's *capability* of analyzing risks (a factor used in both the predecessor and new suitability rules).[74] FINRA stated that a broker-dealer may conclude in some cases that a customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product or investment strategy that is the subject of a recommendation, the scope of a broker's customer-specific obligations under the suitability rule would not be diminished by the fact that the broker was dealing with an institutional customer. However, the fact that a customer initially needed help understanding a potential investment or investment strategy need not necessarily imply that the customer did not ultimately develop an understanding.

As to an institutional customer's affirmative indication that it intends to *exercise independent judgment* (a new requirement), Rule 2111.07 states that "an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account." In its response to comments during the rulemaking process, however, FINRA noted that a broker-dealer "is free to decide as a business matter to service only those institutional investors that are willing to make the affirmative indication in terms of all potential transactions for its account."[75]

Q26. Does the suitability rule require a broker-dealer to have a hard copy agreement on file reflecting an institutional customer's affirmative indication that it intends to exercise independent judgment?

A26. As discussed earlier in the answer to question 12, the suitability rule applies to all recommendations of a security or securities or investment strategies involving a security or securities, but the rule generally allows a firm to take a risk-based approach to documenting suitability. In relation to a customer affirmatively indicating the intention to exercise independent judgment, negative consent will not suffice, but the affirmative indication does not necessarily have to be in writing. A firm may use a risk-based approach to documenting compliance with this provision.

A firm could comply with this requirement, for example, by having an institutional customer indicate in a signed customer agreement or other document that the institutional customer will be exercising independent judgment in evaluating recommendations or a firm could call its institutional customer, have that discussion, and (if it chooses or circumstances require) document the conversation to evidence the institutional customer's affirmative indication.

Endnotes

1. *See* 75 Fed. Reg. 71479 (Nov. 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039). In addition, the SEC's order approved FINRA Rule 2090 (Know Your Customer), which also is effective on July 9, 2012. *See id.*; *Regulatory Notice 11-25*, at 1.

2. FINRA Rule 2111(a).

3. This aspect of the new rule largely codifies case law indicating that brokers generally should consider various customer-specific factors that NASD Rule 2310 did not explicitly reference. FINRA Rule 2111.04 provides, however, that a broker-dealer 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." If a broker-dealer 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. *See Regulatory Notice 11-25*, at 4.

4. FINRA created a model *New Account Application Template*. The template indicates that "investment experience" could include the types of investment products that the customer previously has owned (*e.g.*, mutual funds, exchange-traded funds (ETFs), individual stocks, bonds, options, securities futures, annuities), the number of transactions per year for each category, and the number of years of experience with each category. *See id*. at 5.

   It is important to note that the New Account Application Template is a voluntary model brokerage account form that is provided as a resource to firms when they design or update their new account forms. Firms are under no regulatory obligation to use the template, in whole or in part. FINRA recognizes that firms may continue to use their proprietary application forms, methods and processes, as long as they meet all applicable regulatory requirements. In addition, use of the voluntary template in whole or in part does not guarantee compliance with or create any safe harbor with respect to FINRA rules, the federal securities laws or state laws. Firms are responsible for ensuring that they comply with all regulatory requirements (including, but not limited to, applicable information-gathering and disclosure obligations).

5. "Time horizon" represents the "expected number of months, years, or decades [a customer plans to invest] to achieve a particular financial goal." *Regulatory Notice 11-25*, at 4.

6. "Liquidity needs" represent 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." *Regulatory Notice 11-25*, at 4. FINRA stated that "examples of possible liquid investments include money market funds, Treasury bills and many blue-chip stocks, ETFs and mutual funds." *Id*. at 9 n.11. FINRA emphasized, 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." *Id.*

7. "Risk tolerance" is a customer's "ability and willingness to lose some or all of [the] original investment in exchange for greater potential

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returns." *Regulatory Notice 11-25*, at 4. For a discussion of the relationship between time horizon, liquidity needs and risk tolerance, *see* *Regulatory Notice 11-25*, at 5.

8. In many circumstances, a broker should have *actual* knowledge of investments held at the firm where the broker is registered and should use reasonable diligence to ascertain investments held at *other* financial institutions. A broker generally may satisfy the obligation to seek information about investments held at *other* financial institutions by asking the customer for such information.

9. "Financial situation and needs" might include, among other things, a customer's annual income, net worth, liquid net worth, annual (recurring) expenses, and special (non-recurring) expenses. *See* *New Account Application Template*, *supra* note 4, at 4.

10. "Tax status" could include a customer's highest marginal tax rate. *See* *New Account Application Template*, *supra* note 4, at 4.

11. "Investment objectives" might include one or more of the following: generate income; fund retirement; steadily accumulate wealth over the long term; preserve wealth and pass it on to heirs; pay for education; pay for a house; and/or market speculation. *See* *New Account Application Template*, *supra* note 4, at 7.

12. Nothing in this guidance, including the discussions relating to a risk-based approach to documenting compliance with Rule 2111, shall be construed as altering in any manner a broker-dealer's obligations under applicable federal securities laws, regulations and rules, including Securities Exchange Act (SEA) Rules 17a-3 and 17a-4 and the Bank Secrecy Act, 31 U.S.C. §§ 5311, *et seq.*

13. *See* FINRA Response to Comments, Oct. 21, 2010; 75 Fed. Reg. 51310, at 51313-51321 (Aug. 19, 2010) (Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook; File No. SR-FINRA-2010-039) (Notice of Proposed Rule Change).

14. *See* *Regulatory Notice 11-02*, at 7 n.11; SEC Staff Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, at 59 (Jan. 2011) (IA/BD Study). *See also* Notice of Proposed Rule Change, *supra* note 13, at 51314-51315.

15. *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); *see also Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'"); *Dane S. Faber*, 57 S.E.C. 297, 310, 2004 SEC LEXIS 277, at *23-24 (2004) (stating that a "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces in [them]"); *Wendell D. Belden*, 56 S.E.C. 496, 503, 2003 SEC LEXIS 1154, at *11 (2003) ("As we have frequently pointed out, a broker's recommendations must be consistent with his customer's best interests."); *Daniel R. Howard*, 55 S.E.C. 1096, 1100, 2002 SEC LEXIS 1909, at *5-6 (2002) (same), *aff'd*, 77 F. App'x 2 (1st Cir. 2003); *Powell & McGowan, Inc.*, 41 S.E.C. 933, 935, 1964 SEC LEXIS 497, at *3-4 (1964) (same); *Dep't of Enforcement v. Evans,* No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at *22 (NAC Oct. 3, 2011) (same); *Dep't of Enforcement v. Cody*, No. 2005003188901,

2010 FINRA Discip. LEXIS 8, at *19 (NAC May 10, 2010) (same), *aff'd*, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011); *Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) ("[A] broker's recommendations must serve his client's best interests, and the test for whether a broker's recommendations are suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs."); IA/BD Study, *supra* note 14, at 59 ("[A] central aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the best interests of his customer.").

16. *See Epstein,* 2009 SEC LEXIS 217, at *42 (stating that the broker's "mutual fund switch recommendations served his own interest by generating substantial production credits, but did not serve the interests of his customers" and emphasizing that the broker violated the suitability rule "when he put his own self-interest ahead of the interests of his customers").

17. *See Belden*, 56 S.E.C. at 504-05, 2003 SEC LEXIS 1154, at *14.

18. *Epstein*, 2009 SEC LEXIS 217, at *72; *see also Sathianathan*, 2006 SEC LEXIS 2572, at *23.

19. *Robin B. McNabb*, 54 S.E.C. 917, 928, 2000 SEC LEXIS 2120, at *24 (2000), *aff'd*, 298 F.3d 1126 (9th Cir. 1990).

20. *See Stephen T. Rangen*, 52 S.E.C. 1304, 1311, 1997 SEC LEXIS 762, at *19 (1997).

21. *See Curtis I. Wilson*, 49 S.E.C. 1020, 1022, 1989 SEC LEXIS 25, at *6-7 (1989), *aff'd*, 902 F.2d 1580 (9th Cir. 1990).

22. *Howard*, 55 S.E.C. at 1100, 2002 SEC LEXIS 1909, at *6-7.

23. It is important to keep in mind that, in addition to the suitability rule, FINRA has numerous other investor-protection rules. *See, e.g.,* FINRA Rule 2010 (requiring that a broker-dealer, "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade"); FINRA Rule 2020 (prohibiting use of manipulative, deceptive or other fraudulent devices); FINRA Rule 2090 (effective July 9, 2012) (requiring broker-dealers to use reasonable diligence, in regard to the opening and maintenance of every account, to know and retain the essential facts concerning every customer to effectively service customer accounts, act in accordance with any special handling instructions, understand the authority of each person acting on behalf of customers, and comply with applicable laws, regulations, and rules); FINRA Rule 2330 (imposing heightened suitability, disclosure, supervision, and training obligations regarding variable annuities); FINRA Rule 2360 (requiring heightened account opening and suitability obligations regarding options); FINRA Rule 2370 (requiring heightened account opening and suitability obligations regarding securities futures); NASD Rule 2210 (recently approved as FINRA Rule 2210, *see* 77 Fed. Reg. 20452 (Apr. 4, 2012)) (requiring broker-dealers' communications with the public to, among other things, be fair and balanced, include material information, be free from exaggerated, false or misleading statements or claims, and, as to certain communications, be approved prior to use by a principal and/or filed with FINRA); NASD Rule 3010 (imposing supervisory obligations); FINRA Rule 5310 (requiring broker-dealers to provide best execution). Broker-dealers also must

demonstrate to FINRA, through the membership application process, that they are capable of complying with FINRA rules and the federal securities laws, and their registered persons generally must pass one or more examinations to evidence competence in the areas in which they will work and must comply with important continuing education requirements. *See, e.g.,* NASD Rules 1014, 1021 and 1031, and FINRA Rule 1250. These (and many other) FINRA rules provide broad and significant protections to investors. FINRA BrokerCheck®, moreover, allows investors to review the professional and disciplinary backgrounds of firms and brokers online.

24. *See, e.g., Regulatory Notice 11-02*, at 2-3 (discussing FINRA's guiding principles that firms and brokers should consider when determining whether a particular communication could be considered a "recommendation" for purposes of the suitability rule); *Regulatory Notice 10-06*, at 3-4 (Jan. 2010) (providing guidance on recommendations made on blogs and social networking websites); *Notice to Members 01-23* (Apr. 2001) (announcing the guiding principles and providing examples of communications that likely do and do not constitute recommendations); *Michael F. Siegel*, Exchange Act Rel. No. 58737, 2008 SEC LEXIS 2459, at *21-27 (Oct. 6, 2008) (applying the guiding principles to the facts of the case to find a recommendation), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir.), *cert. denied*, 130 S.Ct. 333 (2010).

25. *See, e.g.,* SEC Adoption of Rules Under Section 15(b)(10) of the Exchange Act, 32 Fed. Reg. 11637, 11638 (Aug. 11, 1967) (noting that the SEC's now-rescinded suitability rule would not apply to "general distribution of a market letter, research report or other similar material"); Suitability Requirements for Transactions in Certain Securities, 54 Fed. Reg. 6693, 6696 (Feb. 14, 1989) (stating that proposed SEA Rule 15c2-6, which would have required documented suitability determinations for speculative securities, "would not apply to general advertisements not involving a direct recommendation to the individual"); *DBCC v. Kunz*, No. C3A960029, 1999 NASD Discip. LEXIS 20, at *63 (NAC July 7, 1999) (stating that, under the facts of the case, the mere distribution of offering material, without more, did not constitute a recommendation triggering application of the suitability rule), *aff'd*, 55 S.E.C. 551, 2002 SEC LEXIS 104 (2002); *FINRA Interpretive Letter, Mar. 4, 1997* ("[T]he staff agrees that a reference to an investment company or an offer of investment company shares in an advertisement or piece of sales literature would not by itself constitute a 'recommendation' for purposes of [the suitability rule].").

26. The discussions (and examples provided) in previous *Regulatory Notices*, cases, interpretive letters, and SEC releases remain applicable to the extent that they are not inconsistent with Rule 2111.

27. *See, e.g., Rafael Pinchas*, 54 S.E.C. 331, 341 n.22, 1999 SEC LEXIS 1754, at *20 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 [FINRA's suitability rule]."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11, 1992 SEC LEXIS 2750, at *5 n.11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended).

28. FINRA previously responded to questions regarding whether the absence of a sell order in a discretionary account amounts to an implicit hold recommendation covered by the rule. FINRA stated that, *"[t]o 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." *Regulatory Notice 11-25*, at 10 n.21 (emphasis in original).
29. Pub. L. No. 112-106, 126 Stat. 306 (2012).
30. *See supra* note 25.
31. When analyzing whether a particular communication could be viewed as a recommendation triggering application of the suitability rule, firms should consult the prior guidance cited *supra* at notes 24 and 25.
32. *See* FINRA Rule 0160(b)(4) (Definition of Customer).
33. *See* FINRA Rule 2111.03.
34. *See Regulatory Notice 11-25*, at 6; *Regulatory Notice 11-02*, at 3. However, as described in greater detail *infra* in the answer to question 8, there is a safe-harbor provision for certain types of educational information that otherwise could be considered investment strategies captured by the new rule's broad language. *See* FINRA Rule 2111.03.
35. The "Dogs of the Dow" strategy is premised on investing "equal dollar amounts in the ten constituents of the Dow Jones industrial average with the highest dividend yields, hold[ing] them for twelve months and then switch[ing] to a new group of dogs." Vincent Apicella, *Stock Focus: "Dogs of the Dow" Companies*, Forbes.com (May 29, 2001).
36. *See Notice to Members 04-89* (Dec. 2004) (discussing liquefied home equity).
37. *See* FINRA Rule 2111.03.
38. Nonetheless, FINRA has stated that the safe-harbor provision would be strictly construed. *See Regulatory Notice 11-25*, at 7.
39. FINRA Rule 2111.03. NASD IM-2210-6 (Requirements for the Use of Investment Analysis Tools) will soon be renumbered pursuant to the SEC's recent approval of FINRA Rule 2214. *See* 77 Fed. Reg. 20452 (Apr. 4, 2012). As discussed above in the answer to question 8, Rule 2111.03 provides a safe harbor for firms' use of asset allocation models that are, among other things, based on "generally accepted investment theory." These models often take into account the historic returns of different asset classes over defined periods of time. FINRA expects a firm to be capable of explaining how an asset allocation model that it uses is consistent with generally accepted investment theory.
40. The examples of market sectors discussed in this *Notice* are from the Standard Industrial Classification Code. *See* SEC Division of Corporation Finance: Standard Industrial Classification.
41. When a broker-dealer recommends an allocation strategy that includes an allocation in fixed-income securities, FINRA recognizes that a number of additional factors would be relevant in determining if the broker-dealer has "recommended" particular debt securities. A firm's analysis of whether the identification of a more limited universe of fixed-income securities constitutes a recommendation of particular securities may, depending on the facts and circumstances, differ from its assessment regarding equity securities. The issuers' identities

and creditworthiness are important information in determining whether to purchase a debt security, but there may be other factors that affect the pricing and any decision to invest in specific debt securities. Moreover, the relative importance of the issuers to other factors in making fixed-income investment decisions varies depending on the total mix of the relevant facts and circumstances. Thus, identifying a more limited universe of debt issuers may not constitute a recommendation if such issuers have many debt securities outstanding, of many maturities, and having distinct structures or features.

42. In *Notice to Members 01-23* (Apr. 2001), FINRA explained "that a portfolio analysis tool that merely generates a suggested mix of general classes of financial assets" would not, by itself, trigger a suitability obligation under NASD Rule 2310; however, the more a general class is narrowed (*e.g.*, by providing a list of issuers that fit within the class), the more likely such a communication would be considered a "recommendation." *Id.* at 6 n.15. Firms should use a similar approach to analyzing whether particular recommendations are eligible for the Rule 2111.03 safe-harbor provision.

43. If the recommended investment strategy does not have a security component, the suitability rule would not apply. The suitability rule applies only when the recommended investment strategy involves a security or securities (although, as discussed above in the answer to question 7, a broker's recommendation of a strategy need not mention a particular security or result in a transaction for the rule to apply). While the suitability rule applies only to recommendations involving a security or securities, other FINRA rules potentially apply, depending on the facts of the particular case, to broker-dealers' and associated persons' conduct that does not involve securities. *See, e.g.,* FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade); 2210 (*see supra* note 23) (Communications with the Public); 3270 (Outside Business Activities of Registered Persons); *see also Ialeggio v. SEC*, No. 98-70854, 1999 U.S. App. LEXIS 10362, *4-5 (9th Cir. May 20, 1999) (holding that FINRA's requirement that brokers act in a manner consistent with just and equitable principles of trade applies to all unethical business conduct, regardless of whether the conduct involves securities); *Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996) (same); *Robert L. Wallace*, 53 S.E.C. 989, 995, 1998 SEC LEXIS 2437, at *13 (1998) (emphasizing, in an action involving viatical settlements, that Rule 2210 is "not limited to advertisements for securities, but provide[s] standards applicable to all [broker-dealer] communications with the public").

44. FINRA made similar points regarding recommended investment strategies on several occasions under the predecessor suitability rule. FINRA explained in one instance under the predecessor rule that "recommending liquefying home equity to purchase securities may not be suitable for all investors. [Broker-dealers] should consider not only whether the recommended investments are suitable, but also whether the strategy of investing liquefied home equity in securities is suitable." *Notice to Members 04-89*, at 3 (Dec. 2004). *See also Donna M. Vogt*, AWC No. EAF0400730002 (Feb. 21, 2007) (barring broker for, among other things, recommending to ten customers, many of whom were nearing retirement, that they obtain home equity loans and use the proceeds to purchase securities, without considering whether such recommendations were suitable for such customers in light of their financial situation and

needs); *James A. Kenas*, AWC No. C3B040001 (Jan. 23, 2004) (suspending broker for six months for violating the suitability rule by recommending that his customers use liquefied home equity to purchase mutual fund shares); *Steve C. Morgan*, AWC No. C3A040016 (Mar. 9, 2004) (suspending broker for six months and ordering him to pay restitution of more than $15,000 for recommending that a retired couple use liquefied home equity to purchase a variable annuity).

45. In 2008, FINRA barred a broker, in part, for recommending that some of his customers sell securities to purchase equity indexed annuities (EIAs) that were unsuitable for them. The settlement in *William R. Barto*, Settlement No. 20060043524 (Oct. 27, 2008), states that "Barto recommended to four [of his firm's] customers (two married couples) that they sell or exchange various securities and invest the proceeds in [certain] EIAs, life insurance products sold by Barto as part of an outside business activity approved by [his firm]." *Id.* at 5. The settlement further notes that, "[a]t the time Barto made these recommendations, his customers were at or near retirement and needed immediate access to a large percentage of their funds. The EIAs [at issue], however, [were] long-term, illiquid investments with high surrender penalties that did not match the customers' investment objectives. Based on the financial situations and needs of his customers, Barto did not have reasonable grounds to believe that his recommendations to sell or exchange securities to purchase [the] EIAs were suitable." *Id. See also* *Notice to Members 05-50*, at 5 (Aug. 2005) ("[R]ecommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender[s] are for the purpose of funding the purchase of an unregistered EIA.").

46. *See* NASD Rule 3010 (Supervision).

47. In *Notice to Members 99-45* (June 1999), FINRA explained that the supervision rule "requires that a [firm's] supervisory system be reasonably designed to achieve compliance with applicable laws and regulations. This standard recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations. However, this standard does require that the system be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business." *Id.* at 295. An associated person, of course, is responsible for having a reasonable basis for believing that *each* recommendation he or she makes of a security or securities or investment strategy involving a security or securities is suitable.

48. *See supra* note 3.

49. Firms should keep in mind, however, that SEA Rule 17a-3 requires that, for each account with a natural person as a customer or owner, a broker-dealer must create a record that includes, among other things, the customer's or owner's name, date of birth, employment status, annual income, and net worth, as well as the account's investment objectives. *See* SEA Rule 17a-3(a)(17)(i)(A). SEA Rule 17a-3 also states that the broker-dealer must furnish such customer or owner a copy of the required account record information or alternative document with all information required by SEA Rule 17a-3(a)(17)(i)(A), including an explanation of any terms regarding investment objectives, for verification within 30 days of account opening and at least once every 36 months thereafter. *See* SEA Rule 17a-3(a)(17)(i)(B)(1). "For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record

information required under paragraph (a)(17)(i)(A) of [the Rule] shall excuse the member, broker or dealer from obtaining that required information." SEA Rule 17a-3(a)(17)(i)(C). The account record requirements in paragraph (a)(17)(i)(A) of the Rule apply only to accounts for which the broker or dealer is, or within the past 36 months has been, required to make a suitability determination. *See* SEA Rule 17a-3(a)(17)(i)(D).

50. *See, e.g., Regulatory Notice 12-03* (Jan. 2012) (providing guidance to broker-dealers on supervision and suitability obligations for various complex products); *Regulatory Notice 11-15* (Apr. 2011) (providing guidance on low-priced equity securities in customer margin and firm proprietary accounts); *Regulatory Notice 10-51* (Oct. 2010) (reminding broker-dealers of their sales practice obligations for commodity futures-linked securities); *Regulatory Notice 10-22* (Apr. 2010) (discussing broker-dealer obligations when participating in private offerings); *Regulatory Notice 10-09* (Feb. 2010) (reminding broker-dealers of sales practice obligations with reverse exchangeable securities or reverse convertibles); *Regulatory Notice 09-73* (Dec. 2009) (reminding broker-dealers of their sales practice obligations relating to principal-protected notes); *Regulatory Notice 09-31* (June 2009) (reminding broker-dealers of sales practice obligations relating to leveraged and inverse exchange-traded funds); *Regulatory Notice 08-81* (Dec. 2008) (reminding broker-dealers of their obligations regarding the sale of securities in a high yield environment); *Notice to Members 05-59* (Sept. 2005) (providing guidance to broker-dealers on the sale of structured products); *Notice to Members 05-18* (Mar. 2005) (issuing guidance on section 1031 tax-deferred exchanges of real property for certain tenants-in-common interests in real property offerings); *Notice to Members 03-71* (Nov. 2003) (reminding broker-dealers of obligations when selling non-conventional investments); *Notice to Members 03-07* (Feb. 2003) (reminding broker-dealers of their obligations when selling hedge funds); *Notice to Members 96-32* (May 1996) (providing best practices when dealing in speculative securities); *Notice to Members 93-73* (Oct. 1993) (reminding members of their obligations when selling collateralized mortgage obligations).

51. *See, e.g., Cody*, 2011 SEC LEXIS 1862, at *36-40 (discussing non-investment grade securities); *Wells Fargo Invs., LLC*, AWC No. 2008015651901 (Dec. 15, 2011) (stating that "[r]everse convertibles are complex structured products that combine a debt instrument and put option into one product," the repayment of principal is linked to the performance of an underlying asset, such as a stock, a basket of stocks or an index, which is generally unrelated to the issuer of the note, and at maturity, if the value of the underlying asset has fallen below a certain level, the investor may receive less than a full return of principal); *Chase Invs. Servs. Corp.*, AWC No. 2008015078603 (Nov. 15, 2011) (discussing the potential risk of floating rate loan funds, if substantially invested in secured senior loans that are extended to entities whose credit quality is generally unrated or rated non-investment grade, and the risks of a unit investment trust, if substantially invested in speculative instruments such as non-investment grade "junk" bonds); *Ferris, Baker Watts Inc.*, AWC No. 20070091803 (Oct. 20, 2010) (discussing reverse convertibles exposing investors to risks in addition to those risks associated with investment in bonds and bond funds, and having complex pay-out structures involving multiple variables); *Jeffrey C. Young*, Exchange Act Rel. No. 61247, 2009 SEC LEXIS 4332, at *3-6 (Dec. 29, 2009)

(discussing the risks of recommendations to certain municipalities to engage in a trading strategy involving buying and selling the same long-term, zero-coupon United States Treasury Bonds (also known as Separate Trading of Registered Interest and Principal of Securities or "STRIPS") within the same day or days using repurchase agreements (repos) to finance such purchases, which "significantly increased the risks…as repos effectively allowed the accounts to borrow large amounts of money in order to hold larger positions of STRIPS"); *Siegel*, 2008 SEC LEXIS 2459, at *30-32 (holding that recommendations of a private placement were unsuitable where the offering documents contained "conflicting [and] confusing information" and there "was no other information on which a prospective investor could rely to make an investment decision"); *Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *7-10 (Dec. 19, 2008) (explaining why the debentures at issue presented a "high risk" for investors); *Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *21-23 (June 29, 2007) (describing the speculative nature of three low-priced securities at issue); *Faber*, 2004 SEC LEXIS 277, at *25 (discussing speculative nature of the security of a company that "had no revenues and had never showed any profits"); *Jack H. Stein*, 56 S.E.C. 108, 117, 2003 SEC LEXIS 338, at *15 (2003) (focusing, in part, on risks of using margin); *James B. Chase*, 56 S.E.C. 149, 153 & 156-157, 2003 SEC LEXIS 566, at *7-8 & *13 (2003) (discussing speculative nature of the security of "a start-up company whose business consisted of manufacturing and selling a single product" that was "new and had no established or tested market" and emphasizing the risks associated with overly concentrated securities positions); *Larry I. Klein*, 52 S.E.C. 1030, 1032-1034, 1996 SEC LEXIS 2922, at *5-10 (1996) (explaining risks associated with certain foreign currency debt securities); *Clinton H. Holland, Jr.*, 52 S.E.C. 562, 565, 1995 LEXIS 3452, at *9 (1995) (remarking that securities of companies "with a limited history of operations and no profitability" are speculative); *David J. Dambro*, 51 S.E.C. 513, 515, 1993 SEC LEXIS 1521, at *5 (1993) (discussing risky nature of investing in a company that had a history of operating losses and concentrated its assets in illiquid holdings in other unproven start-up companies in the same industry); *Gordon S. Venters*, 51 S.E.C. 292, 293-94, 1993 SEC LEXIS 3645, at *3-5 (1993) (discussing risky nature of investing in a company when that company "was losing money, had never paid a dividend, and its prospects were totally speculative"); *Patrick G. Keel*, 51 S.E.C. 282, 284, 1993 SEC LEXIS 41, at *5 (1993) ("[O]ptions transactions involve a high degree of financial risk. Only investors who understand those risks, and who are able to sustain the costs and financial losses that may be associated with options trading should participate in the listed options markets."); *F.J. Kaufman and Co.*, 50 S.E.C. 164, 165 n.1, 1989 SEC LEXIS 2376, at *2 n.1 (1989) ("The effect of trading on margin is to leverage any position so that the systematic and unsystematic risks are both greater per dollar of investment.").

52. *Regulatory Notice 11-25*, at 7.

53. Firms are reminded, however, that copies of all communications relating to their business as such and memoranda of brokerage orders are required to be preserved for three years. *See* SEA Rules 17a-3(a)(6) and 17a-4(b)(1) and (b)(4).

54. For an expanded discussion of this issue, *see* *Regulatory Notice 11-25*, at 3-4. *See also supra* note 3.

55. *See DBCC v. Hurni*, No. C07960035, 1997 NASD Discip. LEXIS 15, at *9 (NBCC Mar. 7, 1997) ("A broker has a duty to make recommendations based upon the information he has about his customer, rather than based on speculation."); *see also Stein*, 56 S.E.C. at 114, 2003 SEC LEXIS 338, at *11 (explaining that, when a customer refuses to supply information, a broker must "make recommendations only on the basis of the concrete information that the customer did supply and not on the basis of guesswork"); *Dambro*, 51 S.E.C. at 516-17, 1993 SEC LEXIS 1521, at *9-10 (same).

56. *See Regulatory Notice 11-25*, at 3-4.

57. *See Regulatory Notice 11-25*, at 4.

58. FINRA also previously stated that a customer with multiple accounts at a single firm could have different investment profiles or investment-profile factors (*e.g.*, objectives, time horizons, risk tolerance) for those different accounts. FINRA cautioned, however, that a firm should evidence a customer's intent to use different investment profiles or factors for the different accounts. In addition, FINRA explained that, 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. *See Regulatory Notice 11-25*, at 5.

59. *See supra* note 55 and cases cited therein.

60. Firms should note, however, that SEA Rule 17a-3 requires that, for *each* account with a natural person as a customer or owner, a broker-dealer generally must create a record that includes, among other things, the account's investment objectives. *See* SEA Rules 17a-3(a)(17)(i). *See also supra* notes 12 and 49.

61. FINRA Rule 2111.05(a). The new rule explains that, "[i]n general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the [broker-dealer's] familiarity with the security or investment strategy. A [broker-dealer's] reasonable diligence must provide [it] with an understanding of the potential risks and rewards associated with the recommended security or strategy." *Id.*

62. That is true under case law addressing the predecessor suitability rule as well. *See Cody*, 2011 SEC LEXIS 1862, at *30-32 (stating that a broker can violate reasonable-basis suitability by failing to perform a reasonable investigation of the recommended product and to understand its risks even though the recommendation is otherwise suitable); *Siegel*, 2008 SEC LEXIS 2459, at *28-30 (finding violation for failing to perform reasonable diligence to understand the security). *See also Notice to Members 04-30*, at 341 (Apr. 2004) (discussing broker-dealers' reasonable-basis obligations regarding bonds and bond funds); *Notice to Members 03-71*, at 767 (Nov. 11, 2003) ("[T]he reasonable-basis suitability analysis can only be undertaken when a [broker-dealer] understands the investment products it sells. Accordingly, a [firm] must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.").

63. FINRA previously responded to a question asking whether, for purposes of compliance with the reasonable-basis obligation, it is sufficient that a firm's "product committee," which conducts

due diligence on products, has approved a product for sale. FINRA explained that, although due diligence reviews by such committees can be extremely beneficial (*see, e.g.*, *Notice to Members 05-26* (Apr. 2005)), a firm's approval of a product for sale does not necessarily mean that an associated person has complied with the reasonable-basis obligation. "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." *Regulatory Notice 11-25*, at 8.

FINRA stated that "[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." *Id.* FINRA cautioned, however, that, "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." *Id.*

64. A broker-dealer would have *actual* control, for instance, if it has discretionary authority over the account. *See Peter C. Bucchieri*, 52 S.E.C. 800, 805 n.11, 1996 SEC LEXIS 1331, at *12 n.11 (1996). A broker-dealer would have *de facto* control over an account if the customer routinely follows the broker-dealer's advice "because the customer is unable to evaluate the broker's recommendations and [to] exercise independent judgment." *Harry Gliksman*, 54 S.E.C. 471, 475, 1999 SEC LEXIS 2685, at *7 (1999).

65. FINRA Rule 2111.05(c).

66. Turnover rate is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." *Pinchas*, 54 S.E.C. at 339-40 n.14, 1999 SEC LEXIS 1754, at *17 n.14. Turnover rates between three and six may trigger liability for excessive trading. *See Cody*, 2011 SEC LEXIS 1862, at *48 (finding turnover rate of three provided support for excessive trading); *Dep't of Enforcement v. Stein*, No. C07000003, 2001 NASD Discip. LEXIS 38, at *17 (NAC Dec. 3, 2001) ("Turnover rates between three and five have triggered liability for excessive trading"). A turnover rate greater than six creates a presumption that the trading was excessive. *See Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 (6th Cir. 1990); *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1502 (11th Cir. 1985).

67. The cost-to-equity ratio represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses." *Pinchas*, 54 S.E.C. at 340, 1999 SEC LEXIS 1754, at *18. Cost-to-equity ratios as low as 8.7 have been considered indicative of excessive trading, and ratios above 12 generally are viewed as very strong evidence of excessive trading. *See Cody*, 2011 SEC LEXIS 1862, at *49 & *55 (finding cost-to-equity ratio of 8.7 percent excessive); *Thomas F. Bandyk*, Exchange Act Rel. No. 35415, 1995 SEC LEXIS 481, at *2-3 (Feb. 24, 1995) ("His excessive trading yielded an annualized commission to equity ratio ranging between 12.1% and 18.0%.").

68. In-and-out trading refers to the "sale of all or part of a customer's portfolio, with the money reinvested in other securities, followed by the sale of the newly acquired securities." *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983). A broker's use of in-and-out trading ordinarily is a strong indicator of excessive trading. *Id.*

69. *See* FINRA Rule 2111(b).

70. *See* FINRA Rule 4512(c).

71. *Compare* FINRA Rules 2111(b) and 4512(c) *with* NASD IM-2310-3.

72. FINRA Rule 2111(b).

73. FINRA Rule 2111(b). The institutional-customer exemption does not apply to reasonable-basis and quantitative suitability. *See id.*; *Regulatory Notice 11-02*, at 4-5. Quantitative suitability likely will apply in more limited circumstances with regard to institutional customers than it does as to retail customers. The factors that must exist for an institutional customer to qualify for the exemption may, depending on the facts, negate some of the elements relevant to a showing of a broker's "control" over the account. That will not always be the case, however. *See Pryor, McClendon, Counts & Co.*, Exchange Act Rel. No. 45402, 2002 SEC LEXIS 284, at *20-21 & n.10 (Feb. 6, 2002) (holding that the defendant broker "controlled" the account because he essentially was a co-conspirator with the institutional customer's investment officer, who was authorized to place orders for the institutional customer's account).

74. *See Regulatory Notice 11-02*, at 8 n.24.

75. FINRA Response to Comments, Oct. 21, 2010, at 10.

Regulatory Notice 11-25

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

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

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 obligations[1] 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]

FINRA

Financial Industry Regulatory Authority

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 obtain[8] 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 margin[16] or liquefied home equity[17] 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).

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Regulatory Notice 11-02

January 2011

Know Your Customer and Suitability

SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations

Effective Date: October 7, 2011

Executive Summary

The SEC approved FINRA's proposal to adopt rules governing know-your-customer and suitability obligations[1] for the consolidated FINRA rulebook.[2] The new rules are based in part on and replace provisions in the NASD and NYSE rules.

The text of the new rules is set forth in Attachment A. The rules take effect on October 7, 2011.

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

Discussion

The know-your-customer and suitability obligations are critical to ensuring investor protection and promoting fair dealing with customers and ethical sales practices. As part of the process of developing the consolidated FINRA rulebook, FINRA proposed and the SEC approved FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). The new rules retain the core features of these important obligations and at the same time strengthen, streamline and clarify them.[3] The new rules are discussed separately below.

Notice Type

- Consolidated FINRA Rulebook
- Rule Approval

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topics

- Know Your Customer
- Suitability

Referenced Rules & Notices

- FINRA Rule 2090
- FINRA Rule 2111
- Information Notice 3/12/08
- NASD IM-2210-6
- NASD IM-2310-2
- NASD Rule 2310
- NASD Rule 3110
- NTM 01-23
- NYSE Rule 405
- SEA Rule 17a-3

FINRA
Financial Industry Regulatory Authority

Know Your Customer

In general, new FINRA Rule 2090 (Know Your Customer) is modeled after former NYSE Rule 405(1) and requires firms to use "reasonable diligence,"[4] in regard to the opening and maintenance[5] of every account, to know the "essential facts" concerning every customer.[6] 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."[7] The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation. Unlike former NYSE Rule 405, the new rule does not specifically address orders, supervision or account opening—areas that are explicitly covered by other rules.

Suitability

New FINRA Rule 2111 generally is modeled after former NASD Rule 2310 (Suitability) and 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."[8] The rule further explains that a "customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."[9]

The new rule continues to use a broker's "recommendation" as the triggering event for application of the rule and continues to apply a flexible "facts and circumstances" approach to determining what communications constitute such a recommendation. The new rule also applies to recommended investment strategies, clarifies the types of information that brokers must attempt to obtain and analyze, and discusses the three main suitability obligations. Finally, the new rule modifies the institutional-investor exemption in a number of important ways.

Recommendations

The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case.[10] That remains true under the new rule. FINRA reiterates, however, that several guiding principles are relevant to determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule.

For instance, a communication's content, context and presentation are important aspects of the inquiry. The determination of whether a "recommendation" has been made, moreover, is an objective rather than subjective inquiry.[11] An important factor in this regard is whether—given its content, context and manner of presentation—a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation. Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program. These guiding principles, together with numerous litigated decisions and the facts and circumstances of any particular case, inform the determination of whether the communication is a recommendation for purposes of FINRA's suitability rule.

Strategies

The new rule explicitly applies to recommended investment strategies involving a security or securities.[12] The rule emphasizes that the term "strategy" should be interpreted broadly.[13] The rule is triggered when a firm or associated person recommends a security or strategy regardless of whether the recommendation results in a transaction. Among other things, the term "strategy" would capture a broker's *explicit* recommendation to hold a security or securities.[14] The rule recognizes that customers may rely on firms' and associated persons' investment expertise and knowledge, and it is thus appropriate to hold firms and associated persons responsible for the recommendations that they make to customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation.

FINRA, however, exempted from the new rule's coverage certain categories of educational material—which the strategy language otherwise would cover—as long as such material does not include (standing alone or in combination with other communications) a recommendation of a particular security or securities.[15] FINRA believes that it is important to encourage firms and associated persons to freely provide educational material and services to customers.

Customer's Investment Profile

The new rule includes an expanded list of explicit types of information that firms and associated persons must attempt to gather and analyze as part of a suitability analysis. The new rule essentially adds age, investment experience, time horizon, liquidity needs and risk tolerance[16] to the existing list (other holdings, financial situation and needs, tax status

and investment objectives).[17] Recognizing that not every factor regarding a "customer's investment profile" will be relevant to every recommendation, the rule provides flexibility concerning the type of information that firms must seek to obtain and analyze.[18] However, because the listed factors generally are relevant (and often crucial) to a suitability analysis, 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 seek to obtain information about that factor.[19]

Main Suitability Obligations

The new suitability rule lists in one place the three main suitability obligations: reasonable-basis, customer-specific and quantitative suitability.[20]

- Reasonable-basis suitability requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the firm's or associated person's familiarity with the security or investment strategy. A firm's or associated person's reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.
- Customer-specific suitability requires that a broker have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. As noted above, the new rule requires a broker to attempt to obtain and analyze a broad array of customer-specific factors.
- Quantitative suitability requires a broker who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. Factors such as turnover rate, cost-equity ratio and use of in-and-out trading in a customer's account may provide a basis for finding that the activity at issue was excessive.

The new rule makes clear that a broker must have a firm understanding of both the product and the customer.[21] It also makes clear that the lack of such an understanding itself violates the suitability rule.[22]

Institutional-Investor Exemption

FINRA Rule 2111(b) provides an exemption to customer-specific suitability for recommendations to institutional customers under certain circumstances. The new exemption harmonizes the definition of institutional customer in the suitability rule

with the more common definition of "institutional account" in NASD Rule 3110(c)(4).[23] Beyond the definitional requirements, the exemption's main focus is whether the broker has a reasonable basis to believe the customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies,[24] and whether the institutional customer affirmatively acknowledges that it is exercising independent judgment.[25]

In regard to an institutional investor, a firm that satisfies the conditions of the exemption fulfils its customer-specific obligation,[26] but not its reasonable-basis and quantitative obligations under the suitability rule. FINRA believes that, even when institutional customers are involved, it is crucial that brokers understand the securities they recommend and that those securities are appropriate for at least some investors. FINRA also believes that it is important that a firm not recommend an unsuitable number of transactions in those circumstances where it has control over the account. FINRA emphasizes, however, that quantitative suitability generally would apply only with regard to that portion of an institutional customer's portfolio that the firm controls and only with regard to the firm's recommended transactions.[27]

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 are also 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, 3/12/08* (Rulebook Consolidation Process).

3 To the extent that past *Notices to Members, Regulatory Notices*, case law, etc., do not conflict with new rule requirements or interpretations thereof, they remain potentially applicable, depending on the facts and circumstances of the particular case.

4 FINRA notes that it replaced the term "due diligence" used in former NYSE Rule 405(1) with the term "reasonable diligence" in new FINRA Rule 2090 for consistency with the language used in new FINRA Rule 2111. FINRA did not intend by such action to impair or adversely affect established case law and other interpretations discussing the diligence that is required to comply with know-your-customer or suitability obligations.

5 A broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts. Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information. As with a customer's investment profile under the suitability rule, a firm should verify the "essential facts" about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances. The reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case. Firms should note, however, that SEA Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations.

6 FINRA Rule 2090.

7 FINRA Rule 2090.01.

8 FINRA Rule 2111(a). Former NASD Rule 2310 contained interpretative material (IMs) discussing a variety of types of misconduct. Although FINRA eliminated those IMs, most of the types of misconduct that the IMs discussed were either explicitly covered by other rules or incorporated in some form into the new suitability rule. The exception was unauthorized trading, which had been discussed in IM-2310-2. However, it is well-settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010 (previously NASD Rule 2110). *See, e.g., Robert L. Gardner*, 52 S.E.C. 343, 344 n.1 (1995), *aff'd*, 89 F.3d 845 (9th Cir. 1996) (table format); *Keith L. DeSanto*, 52 S.E.C. 316, 317 n.1 (1995), *aff'd*, 101 F.3d 108 (2d Cir. 1996) (table format); Jonathan G. Ornstein, 51 S.E.C. 135, 137 (1992); *Dep't of Enforcement v. Griffith*, No. C01040025, 2006 NASD Discip. LEXIS 30, at *11-12 (NAC December 29, 2006); *Dep't of Enforcement v. Puma*, No. C10000122, 2003

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Endnotes continued

NASD Discip. LEXIS 22, at *12 n.6 (NAC August 11, 2003). The new suitability rule does not alter that conclusion. Unauthorized trading continues to be serious misconduct that violates FINRA Rule 2010.

9 FINRA Rule 2111(a).

10 *See Michael Frederick Siegel*, Securities Exchange Act Release No. 58737, 2008 SEC LEXIS 2459, at *21 (October 6, 2008) (explaining that whether a communication "constitutes a recommendation is a 'facts and circumstances inquiry to be conducted on a case-by-case basis'"), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 2010 U.S. LEXIS 4340 (May 24, 2010). FINRA has stated that "defining the term 'recommendation' is unnecessary and would raise many complex issues in the absence of specific facts of a particular case." Securities Exchange Act Release No. 37588, 1996 SEC LEXIS 2285, at *29 (August 20, 1996), 61 FR 44100, 44107 (August 27, 1996) (Notice of Filing and Order Granting Accelerated Approval of NASD's Interpretation of Its Suitability Rule).

11 FINRA has repeatedly explained that a broker cannot avoid suitability obligations through a disclaimer where—given its content, context and presentation—the particular communication reasonably would be viewed as a recommendation. *See Notice to Members 01-23* (April 2001). FINRA Rule 2111.02, moreover, explicitly states that a firm or associated person "cannot disclaim any responsibilities under the suitability rule." In the same vein, it is well-settled that a "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces in [them]." *Dane S. Faber*, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (February 10, 2004); *see also Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC August 9, 2004) ("[A] broker's recommendations must serve his client's best interests and the test for whether a broker's recommendations are suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs").

12 *See* FINRA Rules 2111(a) and 2111.03.

13 *Id.*

14 *Id.* The new rule does not, however, broaden the scope of *implicit* recommendations. In limited circumstances, FINRA and the SEC have recognized that implicit recommendations 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 recommended). Although such holdings continue to act as precedent regarding those issues, FINRA notes that nothing in the new rule is intended to change the longstanding application of the suitability rule on a recommendation-by-recommendation basis. The new rule would not apply, for instance, to *implicit* recommendations to hold securities that are transferred into an account.

15 *See* FINRA Rule 2111.03.

Endnotes continued

16 During the rulemaking process, some commenters argued that factors such as a customer's investment experience, time horizon and risk tolerance are ones to be considered when reviewing a customer's portfolio as a whole, not the individual trades. According to those commenters, requiring consideration of such factors on a trade-by-trade basis would prevent customers from creating a diverse portfolio made up of securities with different levels of liquidity, risk and time horizons. FINRA reiterates that a recommendation-by-recommendation analysis and consideration of a customer's investment portfolio are not mutually exclusive concepts. Although suitability is a recommendation-by-recommendation analysis, FINRA Rule 2111 explicitly permits the suitability analysis to be performed within the context of the customer's other investments. In fact, the rule requires (as did the previous suitability rule) firms and associated persons to make reasonable efforts to gather and analyze information about a customer's other investments as part of the suitability review. Moreover, the new rule explicitly covers recommended investment strategies.

17 *See* FINRA Rule 2111(a).

18 *See* FINRA Rule 2111.04.

19 *Id.*

20 *See* FINRA Rule 2111.05.

21 *See* FINRA Rule 2111(a); FINRA Rule 2111.04; FINRA Rule 2111.05(a).

22 *See* FINRA Rules 2111.04 and 2111.05(a).

23 *See* FINRA Rule 2111(b). FINRA is proposing to adopt NASD Rule 3110(c)(4) as FINRA Rule 4512(c), without material change. *See* Securities Exchange Act Release No. 63181 (October 26, 2010), 75 FR 67155 (November 1, 2010) (Notice of Filing Proposed Rule Change; File No. SR-FINRA-2010-052).

24 *See* FINRA Rule 2111(b). FINRA reiterates that, in some cases, the broker may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a broker's customer-specific obligations under the suitability rule would not be diminished by the fact that the broker was dealing with an institutional customer. However, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent decision.

25 FINRA Rule 2111(b).

26 FINRA emphasizes that the institutional-customer exemption applies only if all of the conditions in Rule 2111(b) are satisfied. It is not sufficient, for example, that an institutional customer affirmatively indicates that it is exercising independent judgment in evaluating recommendations. The institutional customer also must meet the definitional criteria and the broker must have a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies.

27 It is axiomatic that the suitability rule applies only to recommended transactions. *See, e.g., Dep't*

Endnotes continued

of Enforcement v. Medeck, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *46 (July 30, 2009) (explaining that transactions that were not recommended could not be used to inflate the cost-to-equity ratio and the turnover rate). Case law also has long established that quantitative suitability "occurs when a registered representative has control over trading in an account and the level of activity in that account is inconsistent with the customer's objectives and financial situation." *Harry Gliksman*, 54 S.E.C. 471, 475 (1999), *aff'd*, 24 F. App'x 702 (9th Cir. 2001); *see also Pinchas*, 54 S.E.C. at 337 (same). In general, the control element "is satisfied if the broker has either discretionary authority or de facto control over the account. De facto control is established when the client routinely follows the broker's advice 'because the customer is unable to evaluate the broker's recommendations and to exercise independent judgment.'" *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34 (citations omitted).

In *Pryor, McClendon, Counts & Co.*, Securities Exchange Act Release No. 45402, 2002 SEC LEXIS 284 (February 6, 2002), the SEC analyzed allegations of churning by focusing on that portion of the city of Atlanta's portfolio that the broker-dealer respondent controlled and those transactions that the respondent recommended. *Id.* at *4, *15-16, *20-23. The SEC also held that, for purposes of churning, the respondent controlled the portion of Atlanta's portfolio at issue because the respondent engaged in a scheme to defraud Atlanta with the city's investment officer, who had authority to trade Atlanta's securities portfolio. *Id.* at *20-21 & n.10 (citing *Smith v. Petrou*, 705 F. Supp. 183, 187 (S.D.N.Y. 1989)).

Attachment A

Below is the text of the new FINRA rules.

* * * * *

2000. DUTIES AND CONFLICTS

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2090. Know Your Customer

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.

• • • Supplementary Material: ------------------

.01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" 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.

* * * * *

2100. TRANSACTIONS WITH CUSTOMERS

2110. Recommendations

2111. Suitability

(a) A member or an associated person must 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. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in NASD Rule 3110(c)(4), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

• • • Supplementary Material: ------------------

.01 General Principles. Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA's rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

.02 Disclaimers. A member or associated person cannot disclaim any responsibilities under the suitability rule.

.03 Recommended Strategies. The phrase "investment strategy involving a security or securities" used in this Rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities. However, the following communications are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities:

(a) General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile;

(b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

(c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with NASD IM-2210-6 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD IM-2210-6; and

(d) Interactive investment materials that incorporate the above.

.04 Customer's Investment Profile. A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person 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.

.05 Components of Suitability Obligations. Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

(b) The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).

(c) Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

.06 Customer's Financial Ability. Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities unless the member or associated person has a reasonable basis to believe that the customer has the financial ability to meet such a commitment.

.07 Institutional Investor Exemption. Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions delineated in that paragraph are satisfied. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.

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Regulatory Notice 07-43

Senior Investors

FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers

September 2007

Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Continuing Education
- Legal
- Registered Representatives
- Senior Management

Key Topic(s)

- Baby Boomers
- Communications with the Public
- Designations and Credentials
- Diminished Capacity
- Fraud
- Retirement
- Sales Practices
- Seniors
- Suitability

Referenced Rules & Notices

- NASD IM-2310-3
- NASD Rule 2110
- NASD Rule 2210
- NASD Rule 2310
- NTM 96-86
- NTM 99-35
- NTM 03-71
- NTM 04-30
- NTM 04-89
- NTM 05-26
- NTM 05-59
- NTM 06-38
- NYSE Information Memo 05-54
- NYSE Rule 472

Executive Summary

One of FINRA's priorities is the protection of senior investors, as well as Baby Boomers who are at or approaching retirement.[1] FINRA's efforts in this area include investor education, member education and outreach, examinations and enforcement. The purpose of this *Notice* is to urge firms to review and, where warranted, enhance their policies and procedures for complying with FINRA sales practice rules, as well as other applicable laws, regulations and ethical principles, in light of the special issues that are common to many senior investors. The *Notice* also highlights, for the consideration of FINRA's member firms, a number of practices that some firms have adopted to better serve these customers.

Questions concerning this *Notice* may be directed to:

- Laura Gansler, Associate Vice President, Office of Emerging Regulatory Issues, at (202) 728-8275;
- James Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; and
- John Komoroske, Vice President, Office of Investor Education, at (202) 728-8475.

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Discussion

The number of Americans who are at or nearing retirement age is growing at an unprecedented pace. The United States population aged 65 years and older is expected to double in size within the next 25 years.[2] By 2030, almost 1 out of every 5 Americans—approximately 72 million people—will be 65 years old or older.[3] Those who are 85 years old and older are now in the fastest-growing segment of the U.S. population.[4] At the same time, Americans are living longer than ever, meaning that retirement assets have to last longer than ever, too. Moreover, fewer and fewer retirees and pre-retirees can rely on traditional corporate pension plans to provide for a meaningful portion of retirement needs. Therefore, the financial decisions made by those who are at or nearing retirement are more important than ever before.

FINRA understands that, as with other investors, levels of wealth, income and financial sophistication vary among older investors. FINRA does not have special rules for senior customers. Firms owe all their customers the same obligations and duties. However, in executing those duties, age and life stage (whether pre-retired, semi-retired or retired) can be important factors, and firms should make sure that the procedures they have in place take these considerations into account where appropriate. Two areas of particular concern to FINRA are the suitability of recommendations to, and communications aimed at, older investors.

Suitability

NASD Rule 2310 requires that in recommending "the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable" for that customer, based on "the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." The rule also requires that, before executing a recommended transaction, a firm must make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and "such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

Although the rule does not explicitly refer to a customer's age or life stage, both are important factors to consider in performing a suitability analysis. As investors age, their investment time horizons, goals, risk tolerance and tax status may change. Liquidity often takes on added importance. And, depending on their particular circumstances, seniors and retirees may have less tolerance for certain types of risk than other investors. For example, retirees living solely on fixed incomes may be more vulnerable to inflation risk than those who are still in the workforce, depending on the number of years those retirees are likely to rely on fixed incomes. Likewise, investors whose investment time horizons afford less time or opportunity to recover investment losses may be disproportionately affected by market fluctuations.

Therefore, firms cannot adequately assess the suitability of a product or transaction for a particular customer without making reasonable efforts to obtain information about the customer's age, life stage and liquidity needs. Other questions to consider include:

- Is the customer currently employed? If so, how much longer does he or she plan to work?
- What are the customer's primary expenses? For example, does the customer still have a mortgage?
- What are the customer's sources of income? Is the customer living on a fixed income or anticipate doing so in the future?
- How much income does the customer need to meet fixed or anticipated expenses?
- How much has the customer saved for retirement? How are those assets invested?
- How important is the liquidity of income-generating assets to the customer?
- What are the customer's financial and investment goals? For example, how important is generating income, preserving capital or accumulating assets for heirs?
- What health care insurance does the customer have? Will the customer be relying on investment assets for anticipated and unanticipated health costs?

Firms should carefully consider the risk of a product with the age and retirement status of the customer in mind, including its market, inflation and issuer credit risk. Investment involves varying degrees of risk and reward. For many investors who are at or nearing retirement, there can be a temptation to reach for yield to maximize retirement income without the appreciation of the concomitant risk. Moreover, it can be difficult for some investors to fully appreciate the risks of certain products or strategies, particularly if they are concerned about running out of money. Yet, especially when investments involve retirement accounts or lump-sum pension plan payments, taking undue risks with funds needed to last a lifetime can be financially disastrous.

Firms do not have an obligation to shield their customers from risks that customers want to take, but they are required to fully understand the products recommended by their registered representatives, to give their customers a fair and balanced picture of the risks, costs and benefits associated with the products or transactions they recommend and recommend only those products that are suitable in light of the customer's financial goals and needs.[5]

This does not mean that all seniors are, or should be, risk-averse, or that any particular product, per se, is unsuitable for older investors. However, certain products or strategies pose risks that may be unsuitable for many seniors, because of time horizon

considerations, liquidity, volatility or inflation risk. Therefore, FINRA's examiners are focusing on recommendations to seniors, particularly those that involve the following:

- ➤ Products that have withdrawal penalties or otherwise lack liquidity, such as deferred variable annuities, equity indexed annuities, some real estate investments and limited partnerships;
- ➤ Variable life settlements;
- ➤ Complex structured products, such as collateralized debt obligations (CDOs);
- ➤ Mortgaging home equity for investment purposes; and
- ➤ Using retirement savings, including early withdrawals from IRAs, to invest in high-risk investments.

Many of these have been the subject of separate rulemaking or other guidance from FINRA in the past. For example, FINRA has repeatedly stated that variable annuities are generally considered to be long-term investments and are therefore typically not suitable for investors who have short-term investment horizons. This is true even of some variable annuities that offer riders specifically designed for seniors, including those offering guaranteed life benefits.[6] We also have issued guidance on the suitability of variable life settlements, which are generally aimed at investors over the age of 70;[7] and the use of home equity for investment purposes.[8] FINRA also is concerned about recommendations that investors use retirement savings, in some cases by making early withdrawals from IRAs pursuant to Section 72(t) of the Internal Revenue Code, to make unsuitable alternative investments.[9]

As we have in the past, we also caution firms that a customer's net worth alone is not determinative of whether a particular product is suitable for that investor, even when the investor qualifies as an accredited investor under Regulation D of the Securities Act of 1933. Over-reliance on net worth is particularly problematic where an investor meets the accredited investor standard based largely on home values, which may represent the largest asset of many senior investors.[10] Simply put, eligibility does not equal suitability.[11]

Firms also are reminded that their suitability obligation applies to institutional customers, as well as retail customers, although the scope of that obligation varies depending on whether the institution is able to independently assess the risk associated with a particular recommendation and is in fact exercising independent judgment.[12] FINRA is concerned about the suitability of recommendations to some pension plans, particularly recommendations involving relatively new, complicated or high-risk asset classes, such as leveraged exchange-traded funds (ETFs) or the equity tranches of some collateralized mortgage obligations (CMOs). As NASD IM-2310-3 points out, even institutional customers that have the general capability to assess risk may not be able to understand a particular instrument, particularly a product that is new or that has significantly different risk and volatility characteristics than other investments made by the institution. Therefore, in making recommendations to institutional customers, including pension plans, firms should consider both the general ability of the institution to independently assess investment risk, and whether the customer understands the particular product well enough to exercise that ability with respect to the recommendation.

Communications with the Public

Senior Designations and Credentials

FINRA also is concerned about the proliferation of professional designations, particularly those that suggest an expertise in retirement planning or financial services for seniors, such as "certified senior adviser," "senior specialist," "retirement specialist" or "certified financial gerontologist." The criteria used by organizations that grant professional designations for investment professionals vary greatly. Some designations require formal certification, with procedures that include completion of a detailed and rigorous curriculum focused on financial issues, culminating with one or more examinations, as well as mandatory continuing professional education. On the other end of the spectrum, some designations can be obtained simply by paying membership dues. Nonetheless, seniors may be led to believe that these individuals are particularly qualified to assist them based on such designations. A recent FINRA Investor Education Foundation-sponsored survey found that a quarter of senior investors surveyed were told by an investment professional that the investment professional was specially accredited to advise them on senior financial issues, and a half of those investors were more likely to listen to the professional's advice because of it.

Firms that allow the use of any title or designation that conveys an expertise in senior investments or retirement planning where such expertise does not exist may violate NASD Rules 2110 and 2210, NYSE Rule 472, and possibly the antifraud provisions of the federal securities laws. In addition, some states prohibit or restrict the use of senior designations.[13]

NASD Rule 2210 and NYSE 472 prohibit firms and registered representatives from making false, exaggerated, unwarranted or misleading statements or claims in communications with the public. This prohibition includes referencing nonexistent or self-conferred degrees or designations or referencing legitimate degrees or designations in a misleading manner. Firms therefore must have adequate supervisory procedures in place to ensure that their registered representatives do not violate this requirement. As with all supervisory procedures, these procedures should be written, clearly communicated to employees, and effectively enforced. And, they should cover how approved designations may be used.

Some firms FINRA surveyed in connection with the preparation of this *Notice* ban the use of any designation that includes the word "senior" or "retirement." Others maintain a list of approved designations, and a registered representative wishing to use a designation not on the list must submit it for review by a committee consisting of principals, compliance officers and/or legal department personnel. Criteria used by committees to review proposed designations include the curriculum, examinations and continuing education components. To help investors and firms understand professional designations, FINRA maintains a database of such designations and the qualifications, if any, that are needed to obtain them at *http://apps.finra.org/DataDirectory/1/prodesignations.aspx*. Please note, however, that FINRA does not approve or endorse any professional designation, and it maintains the list solely to assist in the evaluation of the listed designations.[14]

In addition to senior designations, FINRA notes that some third-party vendors are marketing ghostwritten books on senior investing to registered representatives as tools to establish credibility. Holding oneself out as the author of a book on senior investing, and therefore an expert, could violate a number of rules, including NASD Rules 2110, 2120 and 2210, and NYSE Rule 472.

High-Pressure Sales Seminars Aimed at Seniors

Another area of concern to FINRA and other regulators is the use of aggressive or misleading sales tactics aimed at seniors, particularly the use of "free lunch" seminars that use high-pressure sales tactics to promote products that may not be suitable for all persons in attendance. Such high-pressure tactics include attempts to create an artificial or inappropriate sense of urgency around major decisions or commitments (*e.g.*, the use of phases such as "limited time offer" or "you have to sign up today") or that heighten or exaggerate typical fears of older investors (*e.g.*, the return of double-digit inflation or becoming financially dependent on family members). In response to these concerns, in May 2006, FINRA conducted a series of on-site examinations of broker-dealers that offer so-called "free lunch" sales seminars aimed at seniors. Other regulators simultaneously conducted similar examinations of investment advisers and other firms that offer such seminars.

In the course of the coordinated examinations, regulators found troubling sales practices, including the use of false or misleading sales materials used in connection with high-pressure sales seminars aimed exclusively or primarily at seniors or those at or nearing retirement. Among the most common practices were inaccurate or exaggerated claims regarding the safety, liquidity or expected returns of the investment or strategy being touted; scare tactics; misrepresentations or material omissions about the product or strategy; conflicts of interest; or misleading credentials used by persons sponsoring or participating in the seminar. The examinations also detected instances in which advertisements failed to include the firm's name, or made improper use of testimonials, in violation of NASD Rule 2210(d). The full discussion of the regulators' findings is presented in *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (Report), available at *www.finra.org/reports.*

FINRA will continue to follow up on the examination findings that relate to its members and will bring disciplinary actions where warranted. We also will continue to pay particular attention to the conduct of firms and their registered representatives in connection with sales seminars that are aimed primarily at seniors. We therefore urge firms to review their policies and procedures relating to sales seminars to make sure they are adequate. In doing so, firms should consult Appendix A of the Report, which contains detailed best practices for supervising sales seminar activities. These practices were identified by regulators in the course of the examinations as elements of effective supervisory procedures.

Diminished Capacity and Suspected Financial Abuse of Seniors

In addition to the regulatory concerns discussed above, there are other issues that firms sometimes encounter when dealing with senior investors. One of the most troubling to the firms we surveyed is that of investors who exhibit signs of diminished mental capacity. Unfortunately, this difficult and sensitive issue is likely to become more common as the ranks of older seniors grow: a recent study published by the National Institute on Aging reveals that impaired cognition affects approximately 20 percent of people aged 85 years or older.

Another troubling issue is suspected financial—and sometimes mental or physical—abuse of senior customers by their family members or caregivers. Financial abuse is difficult to define, and therefore, difficult to recognize. In general terms, it is the misuse of an older adult's money or belongings by a relative or a person in a position of trust. Red flags can include sudden, atypical or unexplained withdrawals; drastic shifts in investment style; inability to contact the senior customer; signs of intimidation or reluctance to speak in the presence of a caregiver; and isolation from friends and family.

These sensitive issues were raised repeatedly by the firms we surveyed for this *Notice*, and we include in this *Notice*, for the consideration of other FINRA members, some of the steps that firms, as a matter of sound business practice and as a way of serving their senior customers, are taking to address them. In doing so, we are not suggesting that firms are required to take these steps, including developing special written supervisory procedures for servicing senior customers. Firms and clients differ, and policies and procedures that work well for one firm may not be appropriate for another. The steps include:

- Designating a specific individual or department, such as the compliance or legal department, to serve as a central advisory contact for questions about senior issues, as well as a repository of available resources.
- Providing written guidance to employees on senior-related issues, such as how to identify and/or what to do if they suspect their customer is experiencing diminished capacity or is being abused, financially or otherwise, by a family member, caregiver or other third party.

  For example, one firm FINRA surveyed has very detailed procedures requiring its employees to immediately notify their branch manager, supervisor or another designated firm employee if they suspect abuse. Under the firm's procedures, that person in turn must notify the firm's legal department, which may decide to report the suspected abuse to the appropriate state agency; restrict activity in the account and/or take any action necessary to comply with appropriate court orders. In addition, the firm requires that the contact with the legal department be documented in the customer's file in accordance with the firm's record retention schedule. The supervisor or branch manager also is instructed to contact local emergency services if immediate physical abuse of a senior investor is suspected.
- Asking, either at account opening or at a later point, whether the customer has executed a durable power of attorney. (Some firms report that it is easier to have conversations with their customers about such sensitive issues as a matter of routine.)

- Asking, either at account opening or at a later time, whether the customer would like to designate a secondary or emergency contact for the account whom the firm could contact if it could not contact the customer or had concerns about the customer's whereabouts or health. (To avoid violating Regulation S-P, firms would have to clearly disclose to the customer the conditions under which the information would be used, and the customer would have the right to withdraw consent at any time.)
- Asking the customer if he or she would like to invite a friend or family member to accompany the customer to appointments at the firm.
- Informing the customer (where appropriate) that, in the firm's view, a particular unsolicited trade is not suitable for the customer.
- Reminding registered representatives that it is important when dealing with customers, particularly seniors, to base recommendations on current information.
- Offering training to help registered representatives understand and meet the needs of older investors, including proper asset allocation, liquidity demand and longevity needs, as well as the possible changes in their suitability profiles. Some relevant materials are available at *www.finra.org* and *www.saveandinvest.org*. Further, some firms have invited representatives from senior-related advocacy groups, the Alzheimer's Association, and state and local agencies that serve seniors to speak to their employees. Organizations that can help firms locate local experts on senior issues include the National Association of State Units on Aging (*www.nasua.org*), the National Association of Area Agencies on Aging (*www.n4a.org*) and AARP (*www.aarp.org*).

Investor Education

Finally, we urge firms to be proactive in helping to educate customers about how to avoid being victims of financial fraud, including making investor education materials, prepared by FINRA, the SEC, state regulators, the firm or another source, available to senior investors.[15] Registered representatives are often in a unique position to help customers learn about how to avoid fraudulent solicitations. We encourage our member firms and associated persons to talk with all of their customers, particularly seniors and others at high risk of being targeted, about how to spot scams and protect themselves and their families from financial fraud.[16]

Conclusion

Given the unprecedented number of investors who are at or nearing retirement age, protecting older investors is a priority for FINRA, and we urge firms to make it a priority, as well. We recognize that seniors are not all alike, and we stress that all investors are entitled to honesty and integrity from their broker-dealers. We remind firms to make sure that the policies and procedures that they do have, as well as relevant training materials, adequately take into account the special needs and concerns that are common to many investors as they age.

Endnotes

1 For ease of reference, this *Notice* refers to both categories as seniors unless the context requires a more specific reference.

2 *See* Wan He *et al*., U.S. Census Bureau, Current Population Reports, P23-209, *65+ in the United States: 2005,* U.S. Government Printing Office, Washington, D.C. (2005), available at *www.census.gov/prod/2006pubs/p23-209.pdf*.

3 *Id.*

4 *See* Wan He *et al*., U.S. Census Bureau, Current Population Reports, P23-209, *65+ in the United States: 2005,* U.S. Government Printing Office, Washington, D.C. (2005), available at *www.census.gov/prod/2006pubs/p23-209.pdf. See also* Frank B. Hobbs, U.S. Census Bureau, The Elderly Population, U.S. Government Printing Office, Washington, D.C. (2001), available at *www.census.gov/population/www/pop-profile/elderpop.html*.

5 A broker must refrain from making an unsuitable recommendation even if the customer expressed an interest in engaging in the inappropriate trade or asked the broker to make the recommendation. *See, e.g., Dane S. Faber,* Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (Feb. 10, 2004).

6 *See* NASD *Notice to Members (NTM) 96-86* (December 1996) and *NTM 99-35* (May 1999). In *NTM 99-35* and in NYSE *Information Memo 05-54* (August 11, 2005), we outlined a series of "best practices" and critical criteria relating to sales of variable annuities. While some members have voluntarily adopted many of those practices, others have not. Because some firms continue to engage in problematic sales practices in this area, and some investors continue to be confused by certain features of these products, we have adopted a rule (Rule 2821) that establishes suitability, disclosure, principal review, and supervisory and training requirements, all tailored specifically to transactions in deferred variable annuities. *See* Exchange Act Release No. 56375 (Sept. 7, 2007) (SR-NASD-2004-183). *See also www.finra.org/RulesRegulation/RuleFilings/2004RuleFilings/P012781.*

7 *See NTM 06-38* (August 2006).

8 *See NTM 04-89* (December 2004). Other relevant *Notices* include *NTM 03-71* (November 2003) (relating to non-conventional instruments); *NTM 04-30* (April 2004) (relating to bonds and bond funds); *NTM 05-26* (April 2005) (relating to vetting new products); and *NTM 05-59* (September 2005) (relating to structured products).

9 IRS Section 72(t) permits penalty-free withdrawals from IRAs before the age of 59½ pursuant to a series of substantially equal periodic payments. Some registered representatives tout Section 72(t) as a "loophole" that allows investors to retire early by withdrawing assets and investing them in products or strategies that offer higher rates of return. In some cases, the registered representative may promise that the investments will generate returns high enough to allow the investor to maintain a standard of living that is equal to or even higher than they did while working. However, the promised rate of return may be unrealistically high, and investors may not fully appreciate the potential downside to such strategies, including the potential loss of their home, or the depletion of their retirement assets.

10 On December 27, 2006, the SEC published for comment proposed changes to Regulation D that would establish a new "accredited natural person" requirement for investments in "private investment vehicles." The new standard would exclude the equity in a primary residence from the calculation of an accredited natural person's investment assets. The Commission has not yet adopted the proposal. *See* Securities Act Release No. 8766 (December 27, 2006) (SEC File No. S7-25-06).

11 *See* Securities Act Release No. 8766 (December 27, 2006) (SEC File No. S7-25-06). *See also* Securities Act Release No. 8828 (August 3, 2007) (SEC File No. S7-18-07).

Endnotes (cont'd)

12 *See* NASD IM-2310-3, which outlines certain factors that may be relevant when considering compliance with Rule 2310(a) in connection with recommendations to institutional customers. Two important considerations in determining the scope of a firm's suitability obligations to institutional customers are the customer's ability to evaluate investment risk independently, and the extent to which the customer is exercising that ability in connection with the recommendation.

13 For example, Nebraska prohibits the use of senior designations, while Massachusetts permits the use of designations only if they have been approved by an independent accreditation agency. *See Interpretative Opinion No. 26: Use of Certifications and Designations in Advertising by Investment Adviser Representatives and Broker-Dealer Agents,* Special Notice of the Nebraska Department of Banking and Finance (November 13, 2006), available at *www.ndbf.org/forms/bd-ia-special-notice.pdf.* The Massachusetts regulations became effective June 1, 2007. *See* 950 Mass. Code Regs. 12.204(2)(i) (2007) (*Registration of Broker-Dealer, Agents, Investment Adviser, Investment Adviser Representatives and Notice Filing Procedures*), and the Notice of Final Regulations, available at *www.sec.state.ma.us/sct/sctpropreg/propreg.htm.* Further, as of the date of this *Notice*, the North American Securities Administrators Association, Inc. (NASAA) is developing a model rule that would "mak[e] it a separate violation of law to use a designation or certification to mislead investors. Once the model rule has been released for public comment and ultimately approved by the NASAA membership, [NASAA] will urge its adoption in every jurisdiction." Testimony of Joseph P. Borg, Director, Alabama Securities Commission and NASAA President, Before the Special Committee on Aging, United States Senate (September 5, 2007).

14 Firms that are aware of designations that are not included in FINRA's database are invited to provide us with the relevant information so that we may include them.

15 For relevant materials, visit the FINRA Investor Education Foundation's Web site, *www.saveandinvest.org*.

Endnotes (cont'd)

16 To better understand why older investors fall prey to investment fraud, the FINRA Investor Education Foundation funded researchers that analyzed undercover tapes of fraud pitches and surveyed victims and non-victims to determine how they differ. Some of the key research findings include:

- Investment fraud victims are more financially literate than non-victims;
- Investment fraud criminals use a wide array of different influence tactics—from friendship to fear and intimidation tactics—to defraud the victim;
- Fraud pitches are tailored to match the psychological needs of the victim;
- Investment fraud victims are more likely to listen to sales pitches;
- Investment fraud victims are more likely to rely on their own experience and knowledge when making investment decisions;
- Investment fraud victims experience more difficulties from negative life events than non-victims;
- Investment fraud victims are more optimistic about the future; and
- Investment fraud victims dramatically under-report fraud.

See Off the Hook Again: Understanding Why the Elderly Are Victimized by Economic Fraud Crimes, survey results and analysis prepared for WISE Senior Services by The Consumer Fraud Research Group (2006), available at *www.finrafoundation.org/WISE_Investor_Fraud_Study_Final_Report.pdf.*

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NATIONAL SENIOR INVESTOR INITIATIVE

A Coordinated Series of Examinations

The SEC's Office of Compliance Inspections and Examinations and FINRA

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Executive Summary

One of the primary missions of the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") is the protection of investors, of which senior investors are an important and growing subset. As part of a collaborative effort, staff of the SEC's Office of Compliance Inspections and Examinations ("OCIE")[1] and FINRA (collectively, the "staff") conducted 44 examinations of broker-dealers in 2013 that focused on how firms conduct business with senior investors as they prepare for and enter into retirement. These examinations focused on investors aged 65 years old or older; this report refers to these investors as "senior investors."

This report highlights recent industry trends that have impacted the investment landscape and prior regulatory initiatives that have concentrated on senior investors and industry practices related to senior investors. Additionally, the report discusses key observations and practices identified during the recent series of examinations. These examinations focused on a broad range of topics, including the types of securities being sold to senior investors, training of firm representatives with regard to senior specific issues and how firms address issues relating to aging (e.g., diminished capacity and elder financial abuse or exploitation), use of senior designations, firms' marketing and communications to senior investors, types of customer account information required to open accounts for senior investors, suitability of securities sold to senior investors, disclosures provided to senior investors, complaints filed by senior investors and the ways firms tracked those complaints, and supervision of registered representatives as they interact with senior investors. OCIE and FINRA staff are providing this information to broker-dealers to facilitate a thoughtful analysis with regard to their existing policies and procedures related to senior investors and senior-related topics and whether these policies and procedures need to be further developed or refined.

Questions concerning this report may be directed to:

- Kevin Goodman, National Associate Director, Office of Broker-Dealer Examinations, OCIE, SEC;
- Suzanne McGovern, Assistant Director, Office of Broker-Dealer Examinations, OCIE, SEC;
- John LaVoie, Supervisory Examiner, Office of Broker-Dealer Examinations, OCIE, SEC;
- Lisa Stepuszek, Director, Regulatory Programs, FINRA; and
- Leonard Derus, Associate Director, Regulatory Programs, FINRA.

Background on the Senior Investor Initiative

Introduction

The "Baby Boomers," those born between 1946 and 1964, began turning 65 in 2011. According to the most recent U.S. Census Bureau data, over 41 million people living in the United States, or more than 13% of the population, were 65 or older in 2011.[2] Moreover, the number of seniors living in the United States will increase dramatically in the future. For example, the number of people aged 65 or older is projected to be more than 79 million in 2040, which is over twice as many as in the year 2000.[3]

Over the past quarter century, this demographic has made dramatic economic gains. Housing has been a key driver of this wealth trend as well as strong market performance during that time period.[4] The Dow Jones Industrial Average increased from 2,031 points on May 31, 1988 to 16,717 points on May 30, 2014, a gain of nearly 723%.[5] As the Baby Boomers have begun to retire, they have started to draw from Social Security, savings, retirement accounts, and established home equity. Similar to previous generations, they typically purchase conservative income-producing investments as a source of reliable income streams during retirement.

From 2007 to 2010, however, the U.S. economy experienced its most substantial downturn since the Great Depression.[6] In response, the Federal Reserve Board took extraordinary steps to help stabilize the U.S. economy and financial system, which included reducing interest rate levels. One result of this economic downturn and the subsequent dramatic fall in interest rates was the significant corresponding decrease in the rate of return on liquid deposits (savings accounts), time deposits (certificates of deposit or "CDs"), and bonds (treasury and municipal). As a result, many senior investors have seen a significant reduction in the income streams on which they traditionally have depended during retirement.

The combination of high levels of wealth and downward yield pressure on conservative income-producing investments may create an environment conducive to the recommendation of more complex, and possibly unsuitable, securities to senior investors as a means of replacing that income stream. Staff is concerned that, after a lifetime of accumulated savings, senior investors may meet the financial and risk threshold requirements to invest in more complex financial securities and that broker-dealers may be recommending unsuitable transactions to these senior investors or may not be providing proper and understandable disclosures regarding the terms and related risks of those recommended securities, particularly non-traditional investments.

Prior Regulatory Initiatives

In September 2007, OCIE and the North American Securities Administrators Association ("NASAA") worked together with the National Association of Securities Dealers ("NASD") and the New York Stock Exchange Member Regulation Inc. (now combined as FINRA) on a

collaborative initiative that included three components: active investor education and outreach to seniors and those nearing retirement age, targeted examinations to detect abusive sales tactics aimed at seniors, and aggressive enforcement of securities laws in cases of fraud against seniors.[7]

As a follow-up to the 2007 report, OCIE, FINRA, and NASAA collectively published a report in September of 2008[8] outlining practices that financial services firms can use to strengthen their policies and procedures for serving investors as they approach and enter retirement. The 2008 report describes new processes and procedures aimed at addressing common issues associated with interactions with senior investors that were implemented by some firms.

In August 2010, OCIE, FINRA, and NASAA published an addendum[9] to update the 2008 report on business practices regarding senior investors. The addendum includes feedback from firms that participated in the prior review and additional practices they may have implemented. The addendum focuses on specific, concrete steps that firms were taking or practices they had implemented since the prior review to identify and respond to issues that are common in working with senior investors. The addendum also includes other practices that staff identified in various industry publications. In addition, the addendum encourages financial services firms to strengthen their policies and procedures for serving senior investors as these investors approach and enter retirement.

Regulatory Guidance

In November 2011, FINRA issued Regulatory Notice 11-52,[10] which addresses the use of certifications and designations that imply expertise or specialty in advising senior investors ("senior designations"). Notice 11-52 outlines findings from a survey of firms that focused on the prevalence of senior designation usage, the extent to which particular senior designations were used or prohibited, and the supervisory systems in place regarding senior designations.

In September 2013, the SEC's Office of Investor Education and Advocacy and NASAA published an Investor Bulletin entitled "Making Sense of Financial Professional Titles."[11] The purpose was to help investors better understand the titles used by financial professionals, such as by noting that the requirements for obtaining and using certain titles vary widely. The Bulletin also warns investors against relying exclusively on a title in determining the expertise of any financial professional. It also encourages investors to evaluate the qualifications of a title held by a financial professional they are considering employing; provides a web-based resource for investors to research a financial professional's title; and stresses that neither the SEC nor state regulators grant, approve, or endorse any financial professional designations.

Also in 2013, eight government agencies issued joint guidance to financial institutions regarding reporting suspected financial exploitation of older adults.[12] This guidance discusses the obligations of firms relating to privacy protections for their investors and the variety of exceptions in cases of suspected financial abuse. In addition, the guidance enumerates possible signs of financial exploitation in older adults that might trigger the filing of a suspicious activity report ("SAR"). A SAR is a document that financial institutions must file with the Financial

Crimes Enforcement Network following, among other things, a suspected incident of money laundering or fraud.[13]

OCIE/FINRA National Senior Investor Initiative

Building on prior regulatory initiatives, OCIE's National Examination Program staff, in coordination with FINRA, initiated a series of 44 examinations of broker-dealers focused on the types of securities senior investors were purchasing and the methods firms were using when recommending securities. In an environment where traditional savings accounts and more conservative investments were earning historically low yields, OCIE and FINRA staff assessed whether broker-dealers were recommending riskier and possibly unsuitable securities to senior investors looking for higher returns or that such senior investors may be making financial decisions without fully appreciating the risks associated with those recommendations.

In connection with the examinations, staff met with representatives from the Consumer Financial Protection Bureau; the AARP Education and Outreach Group; and state regulators from Florida, Colorado, California, Texas, and North Carolina. The purpose of these discussions was to identify risks to senior investors that the industry groups and government agencies had observed, especially in geographic areas known to have large numbers of retirees. The majority of these groups expressed serious concerns about the unsuitable recommendation of high-risk securities, particularly the sale of complex investments, to senior investors.

This initiative was designed as a coordinated effort to protect senior investors, and staff worked collaboratively to ensure that the series of examinations conducted had common goals. Staff used a risk-based approach to identify examination candidates that conducted a retail business and that varied in business model and size. Some factors considered included the types of securities sold, the number of registered individuals, the number of associated independent contractors, and the number of branch offices. Staff also reviewed and considered other factors, such as previous sales practice and supervisory deficiencies, firm and registered individuals' disclosures, and customer complaints. Furthermore, staff received recommendations from SEC regional offices and FINRA district offices as these offices are familiar with the activities of the firms located in their geographic regions. In this initiative, staff reviewed how firms were marketing themselves to seniors; what information they were collecting from seniors relating to financial condition, risk tolerance, and investment objectives; what disclosures firms were providing to seniors; whether recommendations of securities were suitable for seniors; and how the firms were supervising their representatives when dealing with seniors. The examinations also reviewed how firms were training their representatives and supervisors on issues related to aging, such as diminished capacity and elder financial abuse.

In 2015, OCIE and FINRA examination staff will continue to review matters of importance to senior investors.[14]

Securities Purchased by Senior Investors

Examination Observations

The different types of securities being purchased by senior investors in the low interest rate environment present during the review period provide insight into how these investors are attempting to meet their financial goals and evolving needs. Staff asked firms to provide a list of the top revenue-generating securities purchased by their senior investors by dollar amount. The securities consisted of mutual funds, deferred variable annuities ("variable annuities"), equities, fixed income investments, and unit investment trusts ("UITs")/exchange-traded funds ("ETFs"). The examinations revealed that some senior investors purchased other securities such as non-traded real estate investment trusts ("REITs"), alternative investments, and structured products.

Staff observed that the following were among the top five revenue-generating securities at the examined firms based on sales to senior investors:

(1) Open-end mutual funds at 77% of the firms;

(2) Variable annuities at 68% of the firms;

(3) Equities at 66% of the firms;

(4) Fixed income investments at 25% of the firms;

(5) UITs and ETFs at 20% of the firms;

(6) Non-traded REITs at almost 20% of the firms;

(7) Alternative investments such as options, BDCs, and leveraged inverse ETFs at approximately 15% of the firms; and

(8) Structured products at 11% of the firms.

A description of the securities listed above, and potential benefits and risks related to these securities, is included in Appendix B.

Conclusion

Mutual funds, variable annuities, and equities were most often purchased by senior investors. More complex securities such as UITs, REITs, alternative investments, and structured products were also purchased by seniors, but such purchases were less frequent. Due to the wide-ranging

nature of these investment products, it is critical that senior investors are fully informed of the features of any security they are purchasing, including the potential return and associated risks.

Training

Discussion of Relevant Rules

Training is an important tool for firms to help ensure that their representatives understand the needs of senior investors. FINRA Rule 1250(b) requires all broker-dealers to provide continuing education for their representatives, and their training plans must be appropriate for all business activities associated with the firm. This rule requires training programs, at a minimum, to cover the following with respect to their securities recommendations, services, and strategies: general investment features and associated risk factors, suitability and sales practice concerns, and applicable regulatory requirements. There is no requirement that a firm's training address issues specific to senior investors.

Examination Observations

More than 77% of the firms incorporated training specific to senior investors and senior issues in their training plans, typically on an annual basis, to educate employees on the needs of this unique investor group. The training addressed topics such as:

- Ensuring that clients, specifically seniors, were fully informed of the risks involved with each product. For example, one firm trained its representatives on its requirements to evaluate the client's understanding of the recommended product and to confirm completeness of all mandatory acknowledgment forms and disclosures.

- How investment needs change as investors age. For example, one firm's training emphasized that not all products were suitable for the same type of investors. Another firm instructed representatives that they must consider various factors when making recommendations to senior investors, such as current employment, primary expenses, sources of income, fixed or anticipated expenses, liquidity, and investment goals.

- Escalation steps in the event that a representative notices signs of diminished capacity or elder financial abuse. Approximately 13% of the firms specifically told their representatives to notify compliance or supervisory personnel if they suspected diminished capacity or elder financial abuse. For example, training material instructed representatives to contact compliance with a problematic or suspicious situation and to document meetings, conversations, or other exchanges with relatives and others about the situation if the representative had noticed signs of diminished capacity. One firm provided a training module focused on reporting suspected senior financial abuse. The module, among other things, encouraged the firm's representatives to ask questions, confirm who had authorization on the account, contact the at-risk senior (separately from the suspected abuser), and escalate the matter to the appropriate supervisor. Some tips or

red flags which would trigger escalation included atypical or unexplained withdrawals, drastic shifts in investment style, and changes in beneficiaries listed in the IRA.

In addition, 64% of firms reported conducting general training classes and/or classes to educate firm representatives on sensitive matters relating to senior investors. For example, one firm provided a mandatory training class for all representatives focused on elder financial abuse and the exploitation of older adults as well as a new-hire training course on the recognition of senior financial abuse. This training described warning signs that may indicate possible elder financial abuse such as sudden changes in investment approach; changes in behavior of a senior client, which could stem from fear of a family member or guardian; problems reaching the senior in question; or a new family member or contact suddenly attempting to make transactions in the senior client's account without proper authorization. The training also detailed the representative's responsibilities related to those warning signs, in addition to reporting suspicious activity to management and attempting to converse with the elder investor outside the presence of the person influencing or acting on behalf of the elder investor.

Conclusion

FINRA Rule 1250(b) requires firms to have a training plan that is appropriate for all business activities. Senior investors represent a large percentage of the investing population, and training employees on sensitive senior matters is an important step in detecting elder financial abuse, detecting potential diminished capacity, and understanding the needs of senior investors. Staff found that most firms incorporate training specific to senior issues into their training plans.

Notable Practices: Training

- Requiring a series of mandatory continuing education training courses over a 12-month period. Some of the courses cover the stages of mental capacity (full or diminished) and solutions to handling an investor's potential diminished mental capacity (e.g., helping senior investors understand steps they will need to take to handle financial responsibilities, such as execution of a durable power of attorney; suggesting that a family member or third party attend meetings to protect the client's interests; escalating concerns with state agencies and regulators; and documenting all interactions).

- Training supervisory staff to assist personnel in handling an investor's potential diminished capacity and elder financial abuse concerns.

Use of Senior Designations

Discussion of Relevant Rules

Firms may allow their representatives to use senior-specific certifications and professional designations to imply expertise, certification, training, or specialty in advising senior investors.[15] The SEC and FINRA, consistent with other federal agencies, state securities regulators, and self-regulatory organizations ("SROs") do not grant, approve, or endorse any professional designation. FINRA's rule on supervision in effect at the time of the examinations (NASD Rule 3010)[16] required each firm to establish and maintain a system to supervise the activities of each registered person, including their use of designations. This rule was intended to safeguard against the use of designations by firm representatives to deceive investors or to act in an unscrupulous manner. FINRA Regulatory Notice 11-52 reminds firms of their supervisory responsibilities concerning the use of senior designations that suggest expertise, certification, training, or specialty in advising senior investors. Notice 11-52 also highlights sound practices while encouraging firms to bolster their own supervisory procedures.[17]

Examination Observations

State regulators, among others, have identified the use of senior designations in marketing and communications with the public as a possible risk to investors.[18] Firms and their representatives may use these designations to imply expertise or credentials that may be inaccurate or misleading. Some senior designations have requirements including training classes, testing requirements, continuing education, and recognition from an accredited institution. Other designations are less stringent, and some do not have any requirements. The meaning of what these designations entail or the experience they represent can be confusing to any investor who relies on financial professionals to assist them with their financial issues.

Almost 64% of the examined firms allowed their representatives to use senior designations in their sales efforts, and these firms collectively permitted the use of 25 different senior designations. The designations used entailed a wide range of qualifications, some of which included an approved curriculum, continuing education requirement, and recognition by an organization that is accredited by another institution. Some firms prohibited the use of senior designations that did not meet certain minimum curriculum and continuing education requirements. For example:

- 64% of the designations that firms allowed representatives to use required continuing education for the financial professional to maintain the title.

- 44% of the allowed designations were not recognized by any independent accrediting organization.

- Almost 30% of the firms prohibited titles or designations if the corresponding curriculum and continuing education requirement did not meet certain specified standards.

Of the 28 firms that allowed senior designations, 14% did not track which representatives had a senior designation, which may violate FINRA's rule on communications with the public (FINRA Rule 2210) and FINRA's rule on supervision in effect at the time of the examinations (NASD Rule 3010). As noted above, these rules require firms to know how their representatives hold themselves out to the public.

Conclusion

Senior designations have varying requirements, some more rigorous than others. For example, certain designations carry specific qualification requirements, while others have none. As a result, some of these designations may be misleading to the investing public. It is important that all investors not rely solely on a title to determine whether a financial professional has the appropriate expertise. In addition, the use of senior designations should be properly supervised. It may be prudent for firms that allow senior designations to adopt policies to safeguard against possible misuse of those senior designations.

Notable Practices: Senior Designations

- Requiring senior designations to have a verified curriculum, a continuing education element, and accreditation from a recognized independent institution.
- Requiring supervisory approval prior to the use of senior designations.
- Prohibiting the use of senior designations.

Marketing and Communications

Discussion of Relevant Rules

FINRA Rule 2210 includes requirements for a firm's communications with the public, including retail communications. Rule 2210(a)(5) defines retail communications to include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. Rule 2210(b)(1)(A) requires an appropriately registered principal to approve most retail communications before the earlier of its use or filing with FINRA's Advertising Regulation Department.[19] In addition, Rule 2210(c) requires broker-dealers to file certain retail communications with FINRA's Advertising Regulation Department. For example, with certain exceptions, broker-dealers must submit all retail communications concerning registered investment companies within ten business days of first use.

Rule 2210(d)(1) addresses the content standards of firms' communications with the public, which include the following:

- All member communications must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading.

- No member may make any false, exaggerated, unwarranted, promissory, or misleading statement or claim in any communication. No member may publish, circulate, or distribute any communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

- Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor's understanding of the communication.

- Members must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. Communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return, and yield inherent to investments.

- Members must consider the nature of the audience to which the communication will be directed and must provide details and explanations appropriate to the audience.

- Communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion, or forecast.

Rule 2210(f) includes requirements for public appearances. Rule 2210(f)(1) states that the content standards in Rule 2210(d)(1) also apply to public appearances by persons associated with broker-dealers. These public appearances include sponsoring or participating in a seminar, forum, radio, or television interview or otherwise engaging in public appearances or speaking activities that are unscripted and do not constitute retail communications, institutional communications, or correspondence. If an associated person recommends a security during a public appearance, Rule 2210(f)(2) requires the associated person to have a reasonable basis for the recommendation and to disclose certain conflicts of interest. In addition, Rule 2210(f)(3) requires firms to establish written policies and procedures that are appropriate to their business, size, structure, and customers to supervise their associated persons' public appearances. These procedures must provide for the education and training of associated persons who make public appearances as to the firm's procedures, documentation of such education and training, and surveillance and follow-up to ensure that such procedures are implemented and followed. Rule 2210(f)(4) clarifies that scripts, slides, handouts, or other written (including electronic) materials used in connection with public appearances are considered communications for the purposes of Rule 2210, and members must comply with all applicable provisions based on the communications' audience, content, and use (e.g., approval requirements for retail communications and content standards). Unscripted public appearances at a seminar are not subject to the principal pre-use approval requirements of Rule 2210(b)(1)(A).

Rule 17a-4(b)(4) under the Securities Exchange Act of 1934 ("Exchange Act") requires broker-dealers to preserve all of their communications with the public which are subject to FINRA rules. The records must be preserved for a period of not less than three years, the first two years in an easily accessible place.

Examination Observations

Staff reviewed marketing and advertising materials used by the examined firms and observed that the firms and their representatives used diverse approaches to promote services and securities to senior investors. A very small number of firms sent retail communications to senior investors specifically because of their age. Retirement planning was a dominant theme of retail communications focused on attracting senior investors. Other senior-related themes included long-term care insurance, wealth preservation, and wealth transfer. Firms promoted these themes through various channels such as brochures, print and electronic advertisement, newspaper columns, radio and television commercials, and seminars. Retirement seminars were a popular forum for soliciting potential investors, including senior investors.

With regard to radio, at least two firms permitted their representatives to host shows to broadly market the services they provide to investors, often discussing themes that may be appealing to senior investors such as retirement. Staff identified potential rule violations such as misleading advertisements and the failure to properly supervise the content of radio shows.

With regard to seminars, approximately half of the firms permitted representatives to host educational seminars covering a wide variety of investment topics, and at least five firms prohibited representatives from hosting seminars. Many seminars appeared designed to target senior investors, as well as middle-aged investors and investors approaching retirement. For example, some seminars focused on investors who were still working but were transitioning from the accumulation of wealth stage to retirement. Others were designed to discuss possible strategies regarding long-term retirement planning techniques that consider changes to income and when to start drawing from annuities, Social Security, pensions, and other defined benefit plan income.

Of the firms that permitted seminars and other forms of public appearances, staff observed that the firms generally had written supervisory procedures specifically covering this area. The specifics of written supervisory procedures differed among firms. For example:

- Some firms required a designated supervisor to review and pre-approve all materials related to the proposed seminar.

- Some firms stated that invitations to seminars could not imply that products would be sold during the seminar. Further, these firms required supervisors, or appropriate designees, to attend seminars periodically to ensure compliance with all regulatory and firm requirements.

- At least two firms established documentation standards for seminars. For example, some of the procedures required that representatives maintain documentation on the date(s) of the seminar, the title of the seminar, the seminar content, name(s) of firm representative hosting the seminar, the date the material for the seminar was submitted for approval, and the date the supervisor approved the seminar.

- Other firms required representatives to distribute evaluation forms to attendees to solicit feedback. Supervisors were then required to review these forms to help identify any issues of regulatory concern that may violate firm policies or the content requirements of FINRA Rule 2210.

Staff observed instances at two firms where the firm or its registered persons appeared to fail to comply with provisions that were set forth in the firm's written supervisory procedures. For example, deficiencies included the failure to obtain supervisory approval for materials used during seminars and, separately, the failure to maintain evidence of approval of seminar materials in contravention of firm written supervisory procedures that required such approval.

Conclusion

Retirement planning is often a dominant theme in retail communications that firms use to attract senior investors. Long-term care insurance, wealth preservation, and wealth transfer also are

common senior investor-related themes. These communications take a variety of forms including brochures, print and electronic advertisement, newspaper columns, radio and television commercials, and seminars. Firms appeared to generally comply with content standards and rules requiring firms to have written policies and procedures, although staff noted a few instances of potentially misleading advertisements and the potential failure to properly supervise the content of radio shows as well as the potential failure to comply with a firm's written supervisory procedures for seminar materials.

Notable Practices: Marketing and Communications

- Having written supervisory procedures that require supervisory approval to participate in unscripted seminars and other forms of public appearances that are not subject to the principal pre-use approval requirements of FINRA Rule 2210(b)(1)(A).

- Distributing evaluation forms to seminar attendees to solicit feedback which are then reviewed by a supervisor to identify any issues of concern that may violate firm policies or the content requirements of FINRA Rule 2210(d)(1).

Account Documentation

Discussion of Relevant Rules

Both the SEC and FINRA have rules regarding the minimum information that firms must obtain and maintain for each customer account. Exchange Act Rule 17a-3(a)(17)(i)(A) requires broker-dealers to make and keep current a record for each customer account that includes the customer's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; however, financial information for the individual joint owners may be combined. The account record must indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the member, broker or dealer. Rule 17a-3(a)(17)(i)(B) requires firms to furnish each customer with a copy of his or her account record within 30 days of opening the account and at least every 36 months thereafter. Furnishing account records is an important tool to help customers and firms promote the accuracy of investment profiles. This is of particular importance to senior investors due to changing liquidity needs and evolving objectives and risk tolerances, such as when investors move from accumulating assets to using assets to provide income during retirement.[20] Rule 17a-3(a)(17)(i)(B) also requires firms to notify customers of name or address changes of the customer or owner and to send updated customer account records reflecting changes in the account's investment objectives within 30 days.

FINRA Rule 4512(a)(1) requires, among other items, that a firm maintain the following information for each customer account: the customer's name and residence; whether the customer is of legal age; names of any associated persons responsible for the account, and if multiple individuals are assigned responsibility for the account, a record indicating the scope of their responsibilities with respect to the account; and signature of the partner, officer, or manager denoting that the account had been accepted in accordance with the member's policies and procedures.

Additionally, FINRA Rule 2090 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 and the authority of each person acting on behalf of such customer. FINRA has provided a "New Account Application Template" or voluntary model brokerage account form that firms may use as a resource when they design or update their new account forms.[21]

Examination Observations

Staff reviewed the types of information firms collected when opening accounts for senior investors to assess compliance with applicable rules. Approximately 98% of the firms collected

the information for new customer account records required by the rules. At least 30% of the firms obtained more information than what is required, including detailed expense information (including short and medium-term expenses), retirement status, whether there was a durable power of attorney, mortgage-related information, insurance policy information, healthcare needs, sources of income (whether those sources are fixed or will be in the future), savings for retirement, and future prospects for employment. In addition, at least 23% of the firms adopted FINRA's New Account Application Template or a variation. The firms that did not use the template used customized, firm-specific new account forms or multiple documents to obtain the required customer information.

Staff also assessed firms' compliance with requirements for updating senior customer account information. Some firms used automated supervisory alerts to help ensure that updated customer investment profiles accurately reflected changes in customers' personal and financial circumstances. Aged account records were being relied on for recommendations at 32% of the firms; at those firms, some of the account information reviewed was more than 36 months old.

Conclusion

Almost all of the firms appear to be consistently meeting their obligations to collect the required customer account information for senior investors when opening new accounts, and in many cases, firms were obtaining more detailed information than is required by the applicable rules; however, some did not appear to be properly updating account information or appeared to be relying on account records aged more than 36 months. It is important for customer account information to be updated so that it properly reflects customer financial needs, investment objectives, and risk tolerance, among other things.

Notable Practices: Account Documentation

- Obtaining more detailed customer account information than what is required by the applicable rules. For example, firms obtained detailed expense information from customers and calculated both short and intermediate-term expenses, among others.

- Using automated supervisory alerts to help ensure that updated customer investment profiles accurately reflect changes in customers' personal and financial circumstances.

Suitability

Discussion of Relevant Rules

Broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules and has been interpreted as an obligation under the antifraud provisions of the federal securities laws.[22] FINRA Rule 2111 requires firm representatives to have a reasonable basis to believe that a recommended transaction or investment strategy is suitable for the customer based on the information obtained through reasonable diligence to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the representative in connection with the recommendation.

FINRA Rule 2330 includes additional requirements for recommended purchases and exchanges of variable annuities. For example, Rule 2330(b)(1)(A) provides that for a recommended purchase of a variable annuity to be suitable in accordance with Rule 2111, firm representatives must have a reasonable basis to believe that the customers have been informed, in general terms, of the various features (both restrictive and beneficial) of variable annuities; the customers would benefit from certain features of variable; and the particular variable annuity as a whole, including any underlying sub-accounts, riders, and similar product enhancements, are suitable. Rule 2330(b)(1)(B) includes similar requirements for recommending the exchange of a variable annuity, requiring firm representatives to take into consideration factors such as whether customers would incur surrender charges, be subject to the commencement of a new surrender period, lose existing benefits, or be subject to increased fees or charges; whether customers would benefit from product enhancements and improvements; and whether customers have had another variable annuity exchange within the preceding 36 months. In addition, Rule 2330(b)(2) requires firm representatives to obtain, at a minimum, the following information before recommending the purchase or exchange of a variable annuity: customer age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and any other information a reasonable person would need in making recommendations to customers.

Examination Observations

Staff analyzed the suitability of recommendations of variable annuities, alternative investments, mutual funds, structured products, REITs, equities, and municipal bonds to senior investors based on a variety of factors, including the appropriateness of exchanges, excessive fees, concentration of liquid net worth, short investment time horizon, and age.

Staff found evidence indicating that 34% of the firms made one or more potentially unsuitable recommendations of variable annuities. One of the most prevalent factors contributing to questions about these recommendations was the appropriateness of exchanges, especially in light of fees. For example, one firm representative displayed a consistent pattern of recommending that investors exchange variable annuity contracts purchased within the previous 36 months. In one of those cases, an investor funded the purchase of a new contract by selling a contract he had purchased less than three years earlier, incurring a surrender charge, a loss of death benefit, and an increase in fees. In this case, the cost and commissions charged with the new contract along with surrender charges, increased fees, and a new surrender schedule appeared to outweigh the benefits, given the investor's age.

Other factors that prompted staff's further review of recommendations of variable annuities included patterns of a large percentage of investors' liquid net worth being invested in variable annuities, investment time horizons and age not matching features of the product, firm representative not sufficiently collecting investment profile information, and investment objectives that appeared inconsistent with the terms of recommended variable annuities.

Approximately 14% of firms made potentially unsuitable recommendations to purchase alternative investments, which can be difficult to value, involve high purchase costs, have limited historical data, and often lack liquidity. For example, at one firm, representatives failed to consider the age (90) and low income of one investor, and the limited investment experience and "growth and income" investment objectives of another investor. These senior investors held the positions for less than ten days and experienced significant realized losses.

Less than 10% of firms made potentially unsuitable recommendations of other types of securities to senior investors. For example:

- 9% made potentially unsuitable recommendations of mutual funds. In one instance, staff believed that recommendations of C shares were potentially unsuitable because the customer's investment horizon was eleven years or more, the investment objective was income, and the purchase of Class A shares in the same fund would have qualified the customer for breakpoints.

- 7% made potentially unsuitable recommendations for sales of structured notes and market-linked CDs, which often lack liquidity, carry complex risks such as default risk, and are difficult to value. It appeared that firm representatives failed to consider investors' risk tolerances, investment concentrations, the illiquid nature of these securities, and investors' age and time horizon when assessing suitability. For example, representatives made multiple recommendations for market-linked CDs, which exceeded maximum firm thresholds of investable assets and product concentrations. One such recommendation was made to an 87 year-old investor with a moderate risk tolerance, an investment objective of growth, and investment experience that was limited to mutual

funds. The product would not become liquid until the investor was 94 years old, and the investment tied up a significant percentage of the investor's assets.

- 7% of firms made potentially unsuitable recommendations for exchange-traded and non-traded REITs. For example, one firm employed a REIT Trading (switching) program that may have facilitated recommendations of REITS to senior investors. The program involved a recommendation to purchase a non-traded REIT followed by a recommendation to sell the REIT once it became publicly traded followed by a recommendation to buy a new-non traded REIT. In multiple cases, the firm representatives failed to combine orders to obtain volume discount benefits for their customers. In addition, staff cited several instances where firm representatives made the recommendations without adequate suitability information including investment objectives, risk tolerances, and investment experience.

Conclusion

In a low interest rate environment, firms may be recommending non-traditional investments to supplement the income streams of senior investors. Staff found that firms made more potentially unsuitable recommendations for non-traditional securities such as variable annuities, structured products, and REITs than for more traditional securities such as open-end mutual funds, equities, and fixed income investments. Firms must have a reasonable basis to believe that a recommended transaction or investment strategy is suitable for the investor based on the information obtained through reasonable diligence into an individual's investment profile.

Notable Practices: Suitability

- Adopting policies and procedures addressing suitability risks specific to senior investors.
- Requiring firm representatives to memorialize in firm computer systems conversations between the representatives and senior investors relating to the recommendations.
- Drafting product applications that require firm representatives to consider and document crucial investment profile information.
- Establishing strict firm product concentration guidelines for senior investors.

Disclosures

Discussion of Relevant Rules

Section 17(a)(2) of the Securities Act of 1933 ("Securities Act") makes it unlawful for any person in the offer or sale of securities, by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. In addition, Section 5 of the Securities Act requires that firms furnish a prospectus in connection with the offer or sale of mutual funds and variable annuities. Mutual fund and variable annuity prospectuses contain details on the product's objectives, investment strategies, risks, performance, distribution policy, fees and expenses, and fund management.

FINRA Rule 2010 requires members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade. This rule speaks to the necessity of full disclosure in relation to material information without omissions regarding broker-dealer firms and their interactions with investors. In addition, other FINRA rules include additional disclosure requirements for special products, such as variable annuities. For example, FINRA Rule 2330(b)(1)(A)(i) requires firm representatives to describe to customers, in general terms, the various features of variable annuities prior to recommending their purchase or exchange. These features include potential surrender periods and surrender charges, tax penalties, mortality and expense fees, investment advisory fees, potential charges for and features of riders, the insurance and investment components, and market risk.

Examination Observations

Staff asked the examined firms to provide all of their disclosures to senior investors relating to the sale of investment products between January 2012 and October 2012. Staff believes that 89% of the firms provided senior investors with appropriate, detailed, and relevant disclosures concerning the recommended securities.

Staff noted that 68% of the firms had sold variable annuities, as one of the top five revenue-generating products, to their investors. In order to comply with the additional requirements in FINRA Rule 2330, many firms adopted a variable annuity disclosure form to evidence collection of the information required by the rule. This disclosure form described the features of the particular variable annuity such as mortality and expense fees, surrender fees and period, liquidity needs of the investor, all riders and account benefits from the variable annuity, and general information about the variable annuity. The majority of firms required their representatives to fill out and submit this form to supervisory officers prior to the variable annuity transaction.

In addition, firms often required customers to sign the disclosures provided to evidence receipt. These disclosures included the variable annuity application, acknowledgement of receipt of the prospectus, state forms when required,[23] a schedule stating commission percentage breakdown and average fund expense ratio breakdown, mortality and expense fees, surrender fees and years remaining if applicable, and average fund expense ratio. When the variable annuity investment was a significant concentration of the customer's assets, at least two firms required customers to sign a disclosure stating their awareness of the high concentration and their sufficiency of liquid assets to cover expenses. In cases where the investor was exchanging one variable annuity for another, almost 10% of firms provided disclosures that included a variable annuity transfer and exchange form, disclosure of surrender costs versus the benefits of the new products, a product comparison for the old and new products, and the total expenses of switch transactions.

Of the 11% of firms that appeared to fail to provide adequate disclosures to senior investors prior to a transaction, the majority (7%) did so in relation to variable annuity transactions. For example, the section of variable annuity forms or disclosure letters describing the comparative fees and benefits between the current and the proposed annuities was often incomplete. In addition, some firms provided what appeared to be inaccurate and misleading disclosures pertaining to variable annuities, such as by inaccurately disclosing the loss of a death benefit resulting from an exchange or by not clearly communicating, inaccurately describing, or failing to disclose surrender charges.

Staff also observed what appeared to be inaccurate, incomplete, or misleading disclosures in relation to affiliated private placements and REITs. For example, one firm made what appeared to be misrepresentations concerning premiums advanced, guaranteed interest payments, and return of principal, as well as omissions with regard to underpayment of insurance premiums, a 10% fee on amounts advanced, and an $11.7 million tax lien in private placement memorandums and market materials for affiliated private placements. Another firm provided what appeared to be misleading and inaccurate sales literature regarding REITs to customers prior to their solicited purchase and subsequent liquidations. This sales literature touted certain enhancements from the original offering such as lower fees, but the prospectuses revealed that fees for liquidation and operations actually increased.

Conclusion

In general, firms appeared to be providing appropriate disclosure to investors with regard to recommended securities. Staff observed what appeared to be inaccurate or incomplete disclosures primarily related to non-traditional securities such as variable annuities and REITs. Despite general compliance with disclosure requirements, it is important to note that it is unclear how well investors understand the disclosures they receive on recommended securities.

Notable Practices: Disclosures

- Requiring a customer signature on a disclosure form indicating that the customer received a prospectus when purchasing new open-end mutual funds.
- Requiring an explanation of the tax ramifications and alternative investment possibilities for all customers that purchase a variable annuity in an individual retirement account.
- Providing a detailed description of registered representative compensation (both direct and indirect) for each product sold on their website.
- Providing one comprehensive disclosure form that includes simple definitions for industry nomenclature and the schedule of fees and expenses related to specific securities.

Customer Complaints

Discussion of Relevant Rules

Investors dissatisfied with their accounts or the service provided by their registered representative or firm (among other reasons) may file a complaint with the firm, FINRA, the SEC, or other relevant regulatory agencies. Exchange Act Rule 17a-3(b)(18) requires firms to make a record of every written customer complaint (including electronic) received by the firm concerning its associated persons. The record must include the complainant's name, address, and account number; the date the complaint was received; the name of each associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. The rule also requires firms to keep a record indicating that each of its customers has been provided with a notice containing the address and telephone number of the department of the member, broker or dealer to which any complaints as to accounts may be directed. These firms are required to preserve these records for a period of not less than three years, the first two years in an easily accessible place. Exchange Act Rule 17a-4(j) requires registered firms to promptly produce these records to representatives of the SEC upon request.

FINRA Rule 4513(a) requires firms to keep and preserve in each office of supervisory jurisdiction, either a separate file of all written customer complaints that relate to that office (including complaints that relate to activities supervised from that office) and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files in that office containing the correspondence connected with such complaints. Rather than keep and preserve the customer complaint records required under this rule at the office of supervisory jurisdiction, the member may choose to make them promptly available at that office, upon request of FINRA. FINRA also requires firms to preserve customer complaint records for at least four years.

Rule 4513(b) clarifies that for purposes of this rule, "customer complaint" means any grievance by a customer or any person authorized to act on behalf of the customer involving the activities of the member or a person associated with the member in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer.

FINRA Rule 4530(a)(1)(B) requires each member to report to FINRA promptly, but in any event not later than 30 calendar days, after the member knows or should have known of the existence of any written customer complaints involving allegations of theft or misappropriation of funds or securities or of forgery. In addition, Rule 4530(d) requires each member to report to FINRA statistical and summary information regarding written customer complaints in such detail as FINRA shall specify by the 15th day of the month following the calendar quarter in which customer complaints are received by the member. Supplementary Material .08 clarifies that a "customer" includes any person, other than a broker or dealer, with whom the member has engaged, or has sought to engage, in securities activities. It also clarifies that each member must

report the following under Rule 4530(d): any written customer complaint reported under Rule 4530(a)(1)(B), any written grievances by customers with whom the member has engaged in securities activities that involves the member or a person associated with the member, and any securities-related written grievance by customers with whom the member has sought to engage in securities activities that involves the member or a person associated with the member.

Examination Observations

Staff reviewed a sample of complaints received by the firms examined to identify any patterns or trends, to detect potential deficiencies in the handling of senior investor accounts, and to detect issues related to firm activities.

While firms maintained records of investor complaints, at least two firms (5%) had difficulty aggregating the number of complaints received from senior investors because they did not track or code the complaints using the age of the customer. Conversely, at least one firm used an internal "senior-related" complaint code which allowed the firm to easily identify senior investor complaints. This use of a senior-related complaint code may help the firm identify issues and concerns specific to senior investors so that they can make necessary changes to:

- improve the effectiveness and the efficiency of their programs;
- identify approaches to manage the increasing challenges of cognitive decline;
- provide products or services that better meet the needs of the senior investors;
- identify and prioritize the underlying risks appropriate to a firm's business; and
- assess the integrity of firm controls to manage senior investor accounts.

Overall, customer complaints involved a wide range of securities and allegations of business conduct issues. The most common complaints among senior investors, with regard to business conduct issues, involved allegations of poor service or unreasonably high fees. Some of the other more common complaints involved allegations of misrepresentations, unsuitable investments, churning, unauthorized trading, and poor advice/recommendations. For example, one senior investor alleged that his account was churned and his registered representative engaged in unauthorized trading between 2007 and 2011. This firm terminated the registered representative after the representative acknowledged using discretion without obtaining prior written authorization. Another customer complaint alleged misrepresentation, unsuitable recommendations, and processing issues. Staff identified apparent deficiencies at the firm including failure to properly code customer complaints, failure to associate a registered representative to complaints, and failure to disclose complaints on the proper form (Form U4).

Conclusion

Staff observed that all of the firms examined were preserving and reporting customer complaints as required by the FINRA rules, but some had difficulty aggregating the number of senior

complaints in their system. The most common complaint themes among senior investors were allegations of poor service and unreasonably high fees.

<u>Notable Practices: Customer Complaints</u>

- Coding complaints as "senior related" in internal systems to enhance a firm's ability to more appropriately respond to senior investors and analyze complaint data.

Supervision

Discussion of Relevant Rules

Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to censure, place limitations on, suspend, or revoke the registration of any broker- dealer who has failed to reasonably supervise persons subject to its supervision with a view to preventing violations of the federal securities laws or rules.

Paragraph (a) of FINRA's rule on supervision in effect at the time of the examinations (NASD Rule 3010)[24] required each member to establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that was reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Rule 3010(a) also clarified that the final responsibility for proper supervision rested with the member. Rule 3010(b) required each member to establish, maintain, and enforce written procedures to supervise the types of business in which it engaged and to supervise the activities of registered representatives, registered principals, and other associated persons that were reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable Rules of NASD.

Under this rule, firms that relied on automated supervisory systems must, at a minimum, require a principal, or principals, of the firm to:

- approve the criteria used in the automated supervisory system;
- audit and update the automated supervisory system as necessary to ensure compliance with applicable FINRA and federal securities rules and regulations; and
- review exception reports produced by the automated supervisory system.

A principal using an automated supervisory system, aid, or tool for the discharge of supervisory duties remained responsible for compliance with this rule.

Many FINRA rules expand on the requirements in NASD Rule 3010 with regard to supervision of specific products and firm activities. For example, FINRA Rule 2330(d) includes additional supervisory and recordkeeping requirements for firms that sell variable annuities. The member also must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in Rule 2330, implement surveillance procedures to determine if any of the member's associated persons are effecting inappropriate exchanges, and have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges. As another example, FINRA Rule 2360(b)(20)(A) requires each member that conducts public customer options business to ensure that its written supervisory system policies and procedures adequately address this options business.

Examination Observations

Staff's review of firm supervision of the business conducted with senior investors focused on firm supervisory processes, written supervisory procedures, exception reporting, internal controls, and compliance reviews. Staff observed that 77% of the firms maintained written supervisory procedures specific to supervision of firm representatives who deal with senior investors. At least 16% of firms used 70 years old as the age for implementing age-based policies and procedures, and at least 5% established age-based policies and procedures for investors as young as 60. Senior-related policies and procedures varied from firm to firm.

A majority of firms' procedures addressed general senior-related supervision, but 11% of firms specifically cited or included some of the themes from FINRA Regulatory Notice 07-43[25] in their written supervisory procedures. This Regulatory Notice addresses firm obligations relating to senior investors and highlights industry best practices, suitability concerns, communications with the public (including use of designations and seminars), and dealing with investors with diminished capacity and occurrences of suspected financial abuse. Topics from the Regulatory Notice addressed in the firms' procedures include the following:

- use of senior designations and credentials;
- approval channels for product recommendations;
- retail communications targeting senior investors;
- luncheon programs and seminars;
- heightened review of product suitability for seniors;
- heightened review of the use of margin accounts by seniors; and
- supervisory requirements to contact senior investors.

Multiple firms had written supervisory procedures that addressed suitability and know-your-customer requirements specifically for senior investors. For at least half of the firms, investor age played a critical role in establishing product suitability guidelines, assessing the suitability of transactions and accounts, and triggering exceptions or red flags. The procedures addressed the importance of obtaining investment profile information and a variety of senior-related topics including:

- dealing with investors who exhibit diminished capacity and other cognitive impairment;
- qualified plan rollovers;
- senior investors' appetite for increasing yield;
- current and future prospects for employment;
- sources of income and whether it is fixed or will be in the future;
- primary expenses including whether the customer still has a mortgage;
- income needed to meet fixed or anticipated expenses;
- savings for retirement and how they are invested;

- health care insurance and future needs to fund health care costs;
- rapid changes to financial profiles based on life events;
- third-party emergency contact information and permission to contact the third party in the event an issue requires clarification; and
- income and estate tax liabilities.

At least 30% of the firms had suitability guidelines for senior investors purchasing certain securities such as variable annuities, non-traded REITs, structured products, low-priced securities, high-yield funds, and other alternative products. At least 23% of the firms maintained such procedures for variable annuities and options. Generally speaking, the suitability product guidelines did not prohibit purchases of a particular product or security by senior investors. Rather, the written supervisory procedures typically included additional requirements or guidelines that firm representatives must follow when senior investors were purchasing certain securities. While these guidelines varied by firm and by customer age, they indicated that firms are paying increased attention to the accounts of senior investors. Examples of these product guidelines or requirements included:

- concentration guidelines for the sale of alternative products to investors who are 75 or older and red flags regarding the sale of variable annuities to senior investors;
- outreach requirements to ensure that investors understood the characteristics of the securities and risks associated with the transactions, such as requiring supervisors to call investors aged 70 or older who purchased variable annuities or requiring compliance departments to speak with customers aged 70 or older who purchased variable annuities and customers aged 75 or older who purchased market-linked CDs;
- heightened supervisory reviews of senior purchases of specific securities;
- pre-approval of purchases by customers aged 70 or older or prohibitions on sales of structured products to customers above a specific age unless the firm granted an exception; and
- exception reports that identified transactions in options securities by senior investors.

Some firms implemented procedures to review transactions by senior investors and/or senior investor accounts over a defined time period to determine whether transactions were suitable and to identify trends. For example, one firm required supervisors to review variable annuity purchases by investors aged 70 or older on a quarterly basis in order to identify potential patterns of inappropriate variable annuity exchanges.

At least three firms used centralized supervisory review groups at their main or regional offices for new accounts or transactions by senior investors. For example, one firm required a centralized supervisory review group to approve new brokerage accounts for investors aged 80 or older and to make initial determinations as to whether the securities to be purchased appeared to be suitable. Other firms required transactions to be routed to a review group based on the product type. One firm had a policy prohibiting investors aged 65 or older from purchasing

variable annuities unless the firm representative documented additional written justifications for the purchases and the centralized review group approved the transaction based on its suitability.

Typically, firms' supervisory structures were supported with some degree of automation. Firms used a wide variety of exception, supervisory, and compliance reports that considered investor age and other factors in tandem, such as liquid net worth, account losses, market performance, or the cost of insurance riders. One firm had as many as 150 suitability, solicitation, and disclosure exception reports for opening and handling accounts for senior investors.

Exception reports typically focused on trends involving the number of senior accounts opened over a defined time period, red flags for individual accounts and transactions, investor losses exceeding $25,000 within a 12-month period, or red flags identifying purchases exceeding 25% of an investor's liquid net worth. Examples of exception reports include the following:

- purchases of $10,000 or more of equity securities by investors aged 65 or older;
- purchases of limited partnerships and unlisted REITs by investors aged 65 or older;
- firm representatives credited with 20 or more initial variable annuity purchases by senior investors during each quarter;
- withdrawals from accounts where a power of attorney has been executed; and
- electronic withdrawals from retirement accounts that may too quickly deplete the account balance when factoring in market performance, a customer's life expectancy, and the quantity of money in an investor's account.

At least seven firms had implemented comprehensive supervisory review systems and processes using automated systems and tools that were integrated with firms' branch supervision and compliance departments. These systems were often complex and contained sophisticated rules that factored in a number of variables that used rule and risk-based scenarios to score investor accounts and transactions. These systems flagged accounts or transactions based on investor characteristics such as age, investment objective, products purchased, and concentration. Generally, the analytic methodologies used in these systems were dynamic, allowing firms to customize the scoring thresholds specifically in senior accounts that would trigger elevated supervisory reviews. Once a transaction or account triggered an exception, firms typically had specific escalation processes for supervisory or compliance review. For example, depending on a firm's protocols, flagged transactions could be escalated to the next level of supervision or to the compliance department.

These systems were developed and supported either by third-party vendors or by the firms. Third-party systems contained exception reporting capabilities that allowed firms to customize exception reports and alerts based on firm criteria to identify questionable account activities. For example, one firm used an automated trade entry system that provided information in different formats for firm representatives and for supervisors or compliance personnel. The view for compliance personnel flagged transactions based on visual cues or risk scores. Color-coded flags based on various factors were used to identify inappropriate or abusive sales practice activity.

Customizing an automated supervisory system enabled firms to react to changing trends within the firm and industry by prioritizing their surveillance programs accordingly.

Conclusion

Most of the firms maintained written procedures related to supervision of firm representatives who deal with senior investors. Firms most frequently used the age of 70 when implementing age-based policies and procedures, but some firms established age-based policies and procedures for investors as young as 60. While general requirements, suitability requirements, product guidelines, and other supervisory procedures varied by firm and by customer age, they indicated that firms are paying increased attention to the accounts of senior investors. In addition, many firms are paying increased attention to transactions in non-traditional securities and have adopted specific supervisory procedures for investments such as variable annuities, non-traded REITs, structured products, and other alternative products. Finally, firm supervisory structures typically are supported by automated systems, which help firms identify and address issues related to senior investors.

Notable Practices: Supervision

- Establishing firm policies that address FINRA Regulatory Notice 07-43, which discusses enhanced suitability practices, communications, dealing with investors suffering from diminished capacity, and occurrences of suspected financial abuse.
- Maintaining product suitability guidelines for senior investors purchasing complex or alternative products such as variable annuities, equity-indexed annuities, REITs, and options.
- Using a centralized supervisory review group to approve transactions and new accounts.
- Using automated systems and tools that are integrated with firm's branch supervisory review system and compliance departments.

Conclusion

OCIE and FINRA staff regard compliance with laws, rules, and regulations applicable to dealings with senior investors to be a high regulatory priority, and the importance of this topic is likely to continue for both regulators and broker-dealers for many years.

The current environment, where traditional savings accounts and other conservative investments are earning historically low yields, may prompt firms to recommend and senior investors to purchase more non-traditional securities, such as variable annuities, non-traded REITs, structured products, and other alternative products. OCIE and FINRA staff are concerned that broker-dealers may be recommending unsuitable securities to senior investors or failing to adequately disclose the related risks. It is imperative that senior investors receive proper and understandable disclosures regarding the terms and risks related to securities recommended to them, particularly non-traditional investments.

This report highlights recent industry trends that have impacted the investment landscape and discusses the key observations and practices identified during the recent series of examinations with regard to securities sold to senior investors, training, use of senior designations, marketing and communications, account documentation, suitability, disclosures, customer complaints, and supervision. OCIE and FINRA staff are providing this information to broker-dealers to support their thoughtful analysis of their policies and procedures as they serve the needs of senior investors.

This Report is intended to highlight for firms risks and issues that staff of the SEC's Office of Compliance Inspections and Examinations and FINRA identified in the course of examinations of broker-dealers. In addition, this Report describes practices, issues, or factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to risks and issues involving senior investors and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, and they constitute neither a safe harbor nor "checklist." Other factors besides those described in this Report may be appropriate alternatives or supplements to consider, and some of the factors may not be applicable to a particular firm's business. They do not present any legal opinion or advice. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance, and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

Appendix A – Reference Material for Firms

Examination Priorities for 2015

- OCIE, SEC, Examination Priorities for 2015
  http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf
- FINRA, 2015 Regulatory and Examination Priorities Letter
  http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf

Securities

- Office of Investor Education and Advocacy ("OIEA"), SEC, Mutual Funds: A Guide for Investors
  http://investor.gov/sites/default/files/mutual-funds.pdf
- OIEA, SEC Investor Bulletin: Variable Annuities – An Introduction (February 2014)
  http://www.sec.gov/investor/alerts/ib_var_annuities.pdf
- FINRA Investor Alert: Public Non-Traded REITS – Perform a Careful Review Before Investing
  http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/REITS/P124232

Training

- FINRA Rule 1250: Continuing Education Requirements
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10204

Senior Designations

- OIEA SEC-NASAA Investor Bulletin: Making Sense of Financial Professional Titles (September 2013)
  http://www.sec.gov/investor/alerts/ib_making_sense.pdf
- OIEA, SEC Investor Information, "Senior" Specialists and Advisors: What You Should Know About Professional Designations
  http://www.sec.gov/investor/pubs/senior-profdes.htm
- NASD Rule 3010: Supervision (superseded by FINRA Rules 3110 and 3170)
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11763
- FINRA Rule 3110: Supervision (there are revisions that will be effective July 1, 2015)
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=15446

- FINRA Regulatory Notice 11-52: Senior Designations (November 2011) *http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125092.pdf*
- FINRA, Senior Designations *http://www.finra.org/industry/issues/seniors/p124734*
- CFPB, Senior Designations for Financial Advisers: Reducing Consumer Confusion and Risks (April 2013) *http://files.consumerfinance.gov/f/201304_CFPB_OlderAmericans_Report.pdf*
- North American Securities Administrators Association, Regulators Urge Investors to Carefully Check Credentials of 'Senior Specialists' (December 2005) *http://www.nasaa.org/7684/regulators-urge-investors-to-carefully-check-credentials-of-senior-specialists/*

Marketing and Communications

- FINRA Rule 2210: Communications with the Public *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10648*
- Exchange Act Rule 17a-4, Records to be preserved by certain exchange members, brokers and dealers *http://www.ecfr.gov/cgi-bin/text-idx?SID=8e0ed509ccc65e983f9eca72ceb26753&node=17:4.0.1.1.1&rgn=div5#se17.4.240_117a_64*

Account Documentation

- Exchange Act Rule 17a-3, Records to be made by certain exchange members, brokers and dealers *http://www.ecfr.gov/cgi-bin/text-idx?SID=1f5fa29b3dd8174ea183036757d3d99a&node=pt17.4.240&rgn=div5#se17.4.240_117a_63*
- FINRA Rule 2090: Know Your Customer *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858*
- FINRA Rule 4512(a)(1): Customer Account Information *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9958*
- FINRA New Account Application Template *http://www.finra.org/Industry/Tools/P117268*

Suitability

- OIEA, SEC Investor Information, Suitability *http://www.sec.gov/answers/suitability.htm*

- OIEA, SEC Investor Information, SEC Center for Complaints and Enforcement Tips
  http://www.sec.gov/complaint.shtml
    - Tips, Complaints and Referrals Portal
      https://denebleo.sec.gov/TCRExternal/disclaimer.xhtml
- FINRA Rule 2111: Suitability
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859
- FINRA Rule 2330: Members' Responsibilities Regarding Deferred Variable Annuities
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8824
- FINRA Regulatory Notice 13-31: Suitability (September 2013)
  https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p351220.pdf

Disclosures

- Section 17(a)(2) of the Securities Act
  http://www.sec.gov/about/laws/sa33.pdf
- Section 5 of the Securities Act
  http://www.sec.gov/about/laws/sa33.pdf
- FINRA Rule 2010: Standards of Commercial Honor and Principles of Trade
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504
- FINRA Rule 2330: Members' Responsibilities Regarding Deferred Variable Annuities
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8824

Customer Complaints

- Exchange Act Rule 17a-3, Records to be made by certain exchange members, brokers and dealers
  http://www.ecfr.gov/cgi-bin/text-idx?SID=8e0ed509ccc65e983f9eca72ceb26753&node=17:4.0.1.1.1&rgn=div5#se17.4.240_117a_64
- Exchange Act Rule 17a-4, Records to be preserved by certain exchange members, brokers and dealers
  http://www.ecfr.gov/cgi-bin/text-idx?SID=8e0ed509ccc65e983f9eca72ceb26753&node=17:4.0.1.1.1&rgn=div5#se17.4.240_117a_64
- FINRA Rule 4513: Records of Written Customer Complaints
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9959
- FINRA Rule 4530: Reporting Requirements
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9819

Supervision

- Section 15(b)(4)(E) of the Exchange Act
  http://www.sec.gov/about/laws/sea34.pdf
- FINRA Rule 2330(d): Members' Responsibilities Regarding Deferred Variable Annuities (Supervisory Procedures)
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8824
- FINRA Rule 2360(b)(20)(A): Options (Duty to Supervise)
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6306
- NASD Rule 3010: Supervision (superseded by FINRA Rules 3110 and 3170)
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11763
- FINRA Rule 3110: Supervision (there are revisions that will be effective July 1, 2015)
  http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=15446
- NASD Notice to Members 05-50: Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities (August 2005)
  http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014821.pdf

Additional Resources

- SEC Seniors Summit, in coordination with FINRA,NASAA and AARP (September 2007) http://www.connectlive.com/events/secseniorssummit/
- SEC-OCIE, NASAA, and FINRA, Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars (September 2007)
  http://www.sec.gov/spotlight/seniors/freelunchreport.pdf
- SEC-OCIE, NASAA, and FINRA, Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors (September 2008)
  http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf
- SEC-OCIE, NASAA, and FINRA, Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors: 2010 Addendum (August 2010)
  http://www.sec.gov/spotlight/seniors/seniorspracticesreport081210.pdf
- SEC, Senior Investors http://www.sec.gov/divisions/marketreg/seniorinvestors.htm
- SEC Charges Operators of Boiler Room Scheme Targeting Seniors to Invest in Football-Related Scam
  http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539842427
- FINRA Regulatory Notice 07-43: Senior Investors (September 2007)
  http://www.complinet.com/file_store/pdf/rulebooks/NASD07-43.pdf
- FINRA Regulatory Notice 08-27: Misleading Communications About Expertise (May 2008)

http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038522.pdf

- NASD Notice to Members 04-89: NASD Alerts Members to Concerns When Recommending or Facilitating Investments of Liquefied Home Equity (December 2004) *http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p012714.pdf*
- FINRA Investor Alert: "Free Lunch" Investment Seminars – Avoiding the Heartburn of a Hard Sell *http://www.finra.org/investors/protectyourself/investoralerts/fraudsandscams/p036745*
- FINRA Investor Alert: Seniors Beware: What You Should Know About Life Settlements *http://www.finra.org/web/groups/investors/@inv/@protect/@ia/documents/investors/p125848.pdf*
- FINRA Investor Alert: Reverse Mortgages: Avoiding a Reversal of Fortune *http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/RetirementAccounts/P038113*
- FINRA E-Learning Courses *http://www.finra.org/Industry/Education/OnlineLearning/E-learningCourses/index.htm*
    - Senior Investor Issues: Diminished Decisional Capacity
    - Senior Investor Suitability Considerations
    - Supervisory Considerations for Working with Seniors

Appendix B – Description of Securities

Below is a description of the top revenue-generating securities that the examined firms sold to senior investors and some of the potential benefits and risks related to these securities:

(1) Mutual funds pool investor money to purchase securities. Investors may purchase shares in the fund, from the fund itself, or through a broker for the fund. Open-end mutual funds are a type of investment company. They must register under the Investment Company Act of 1940 and issue securities under the Securities Act. Each mutual fund must deliver a prospectus to customers under Section 10(a) of the Securities Act. Risks related to mutual funds may include market risk and the risk derived from its underlying assets. Different types of mutual funds may also be subject to different types or levels of volatility, fees, and expenses.[26]

(2) Variable annuities are securities regulated by the SEC.[27] They are contracts between an investor and an insurance company under which the investor makes a lump sum payment or a series of payments in exchange for periodic payments by the insurer at some agreed upon future date.[28] Variable annuities offer certain potential advantages to investors. For example, they are a tax-deferred investment, offer a range of investment options, and often provide riders such as a guaranteed death benefit or other guarantees. On the other hand, variable annuities may have a surrender period that starts after the initial purchase and may last six to eight years or sometimes as long as ten years. If funds are withdrawn during the surrender period, the insurer will assess a surrender charge, typically a percentage of the amount withdrawn, which declines gradually over the period.

(3) Equities are a type of security that gives holders a share of ownership in a company.[29] Advantages to holding equities may include income from dividends, growth, and liquidity. Equities bear risk such as the potential realized or unrealized losses from market fluctuations.

(4) Fixed income investments include individual bonds and market-linked CDs. These investments may provide payments of a fixed amount on a fixed schedule to the owner for the duration of the investment. Although the consistency in the stream of income may be attractive, there are risks associated with each type of investment. Some risks may include market risk, credit risk, and default risk.[30]

(5) A UIT is a type of investment company that issues redeemable securities; makes a one-time public offering of a specific, fixed number of units; has a termination date that is established when it is created; does not actively trade its investment portfolio; and does not have a board of directors, corporate officers, or an investment adviser to render advice during the life of the trust. The amount of capital invested determines the proportionate share of principal and interest the investor receives from the trust. A UIT may buy back outstanding shares of the trust at the current net asset value, and shares may be redeemed at any time. UITs may carry risks such as illiquidity or inflation risk as well as risks derived from the underlying assets.[31]

(6) An ETF is an investment company that is traded like equity securities on an exchange. Although classified as an open-end company or UIT, it differs in many respects. For example, an ETF does not sell individual shares; investors usually purchase creation units with a basket of securities and subsequently sell those shares on the secondary market or sell creation units back to the ETF. An ETF holds assets such as equities, commodities, or bonds and trades close to its net asset value over the course of the trading day. Most ETFs track an index, a commodity, or a basket of assets such as an equity index or bond index. ETFs seek to achieve their stated objectives on a daily basis. Performance over longer periods of time may differ significantly from the index performance over those time periods. Some ETFs pursue active management strategies and publish their portfolio holdings on a daily basis. These products share many of the same risks as mutual funds.[32]

(7) REITs are corporations, trusts, or associations that own and usually operate income-producing real estate or real estate-related assets. REITs provide investors with a way to earn a share of income produced from commercial real estate without actually owning commercial real estate. Investors can purchase shares of REITs through a broker-dealer, and these shares typically offer high yields. Many REITs are registered with the SEC and are publicly traded on a stock exchange, offering investors a liquid investment in income producing real estate or real estate-related assets. There also are REITs that are registered with the SEC but are not publicly traded on an exchange. These non-traded REITs are generally illiquid investments with limited ability to redeem shares because there is no public market and potentially with high fees associated with their sale.[33]

(8) The definition of an alternative investment can vary, as they generally cannot be directly classified as traditional securities such as stocks or bonds. They can include exchange-traded notes, hedge funds, and private placements. Alternative investments can help investors diversify exposure away from mainstream markets (e.g., because of their low correlation coefficients with both equities and fixed income). Potential risks include difficulty in valuation, potentially high purchase costs and large initial investment, limited historical data, lack of liquidity, and complexity.[34]

(9) Structured securities products include structured notes and other market-linked securities, reverse convertible notes, principal-protected notes, and collateralized debt obligations. Structured products are not defined in the federal securities laws. They are sold in the retail market and usually consist of a traditional security combined with one or more other asset classes, typically a bond and an option component. As a result, structured products typically have some form of option or embedded financial derivative exposure. Structured products may offer investors varying levels of principal protection, high interest payments, leveraged exposure to the underlying asset class, and a fixed maturity date (in most cases), and they may seek to achieve a highly customized risk-return objective. Structured products, however, often carry complex risks, including default risk, lack of liquidity, lack of transparency, and valuation difficulty.[35]

Endnotes

[1] The views expressed herein are those of the staff of OCIE, in consultation with other staff of the Securities and Exchange Commission ("SEC" or "Commission") including the Division of Trading and Markets and in coordination with FINRA. The Commission has expressed no view on the contents of this report. This document was prepared by the SEC staff, in coordination with FINRA, and is not legal advice.
[2] Administration on Aging Administration for Community Living, U.S. Department of Health and Human Services, A Profile of Older Americans: 2012, page 1 (2012), available at http://www.aoa.gov/Aging_Statistics/Profile/2012/docs/2012profile.pdf.
[3] Id. at 3.
[4] Richard Fry, D'Vera Cohn, Gretchen Livingston, and Paul Taylor, The Rising Age Gap in Economic Well-being: The Old Prosper Relative to the Young, Pew Research Center, pages 1-2 (November 7, 2011), available at http://www.pewsocialtrends.org/files/2011/11/WealthReportFINAL.pdf.
[5] Dow Jones Industrial Average, available at http://finance.yahoo.com/echarts?s=%5EDJI.
[6] Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances, Federal Reserve Bulletin, Vol. 98, No. 2 (June 2012), page 4, available at http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf.
[7] Office of Compliance Inspections and Examinations Security and Exchange Commission, North American Securities Administrators Association, Financial Industry Regulatory Authority, Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars, page 2 (September 2007), available at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.
[8] Securities and Exchange Commission's Office of Compliance Inspections and Examinations, North American Securities Administrators Association, and Financial Industry Regulatory Authority, Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors (September 22, 2008), available at http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf.
[9] U.S. Securities and Exchange Commission's Office of Compliance and Inspections and Examinations, North American Securities Administrators Association, and Financial Industry Regulatory Authority, Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors 2010 Addendum (August 12, 2010), available at http://www.sec.gov/spotlight/seniors/seniorspracticesreport081210.pdf.
[10] FINRA Regulatory Notice 11-52: FINRA Reminds Firms of Their Obligations Regarding the Supervision of Registered Persons Using Senior Designation (November 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125092.pdf.
[11] SEC-NASAA Investor Bulletin: Making Sense of Financial Professional Titles (September 2013), available at http://www.sec.gov/investor/alerts/ib_making_sense.pdf.
[12] Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, Federal Trade Commission, National Credit Union Administration, Office of the Comptroller of the Currency, and Securities and Exchange Commission, Interagency Guidance on Privacy Laws and Reporting Financial Abuse of Older Adults (2013), available at http://www.sec.gov/news/press/2013/elder-abuse-guidance.pdf.
[13] 12 CFR 208.62.
[14] The SEC's Examination Priorities for 2015 are available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf, and FINRA's 2015 Regulatory and Examination Priorities are available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf.
[15] FINRA, Senior Designations, available at http://www.finra.org/industry/issues/seniors/p124734.
[16] NASD Rule 3010 (a, b, c, d, and g) has been superseded by FINRA Rules 3110 and 3170. Retired NASD Rule 3010 is available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11763.

[17] See FINRA Regulatory Notice 11-52: FINRA Reminds Firms of Their Obligations Regarding the Supervision of Registered Persons Using Senior Designation (November 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125092.pdf.
[18] North American Securities Administrators Association, Regulators Urge Investors to Carefully Check Credentials of 'Senior Specialists' (December 12, 2005), available at http://www.nasaa.org/7684/regulators-urge-investors-to-carefully-check-credentials-of-senior-specialists/.
[19] FINRA Rule 2210(b)(1)(C) and (b)(1)(D) provide certain exceptions from this requirement. For example, pursuant to FINRA Rule 2210(b)(1)(C), principal review is not required for communications which another broker-dealer filed with FINRA's Advertising Regulation Department and received a letter from the Department stating that the communication appears consistent with applicable standards. Also, FINRA Rule 2210(b)(1)(D) exempts from prior to use principal review any retail communication that is posted in an online interactive forum so long as the broker-dealer supervises the use of such communications in the same manner as required for supervising and reviewing correspondence pursuant to NASD Rule 3010(b).
[20] Using customer account records that are aged more than 36 months may increase the likelihood of unsuitable recommendations due to potential changes in customers' personal and financial circumstances.
[21] The voluntary template was created with input from industry professionals and other regulators to present investor with information in a clear, intuitive format. The template includes instructions and other information presented in plain English, highlights of key disclosures, and incorporation of related investor education information. For additional information, see http://www.finra.org/Industry/Tools/P117268.
[22] See Section 5(1)(2) of the Guide to Broker-Dealer Registration, Division of Trading and Markets, U.S. Securities and Exchange Commission (April 2008), available at http://www.sec.gov/divisions/marketreg/bdguide.htm.
[23] Numerous individual states prescribe specific form requirements for insurance sales. These form templates are developed and distributed by the states to the insurance carriers. The carriers then incorporate and provide the forms to the insurance agencies that offer the product.
[24] NASD Rule 3010 (a, b, c, d, and g) has been superseded by FINRA Rules 3110 and 3170. Retired NASD Rule 3010 is available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11763.
[25] FINRA Regulatory Notice 07-43: FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers (September 2007), available at http://www.complinet.com/file_store/pdf/rulebooks/NASD07-43.pdf.
[26] For additional information, see "Mutual Funds," available at http://www.sec.gov/answers/mutfund.htm.
[27] Annuities, such as fixed annuities, are not securities and are thus not regulated by the SEC; they fall under the purview of state insurance regulators.
[28] For additional information, see "Variable Annuities," available at http://www.sec.gov/answers/varann.htm.
[29] For additional information, see "Stocks," available at http://investor.gov/investing-basics/investment-products/stocks#.VNN73zZOmUl.
[30] For additional information, see "Bonds," available at http://investor.gov/investing-basics/investment-products/bonds#.VL_yozZOnnt.
[31] For additional information, see "Unit Investment Trusts (UITs)," available at http://www.sec.gov/answers/uit.htm.
[32] For additional information, see "Exchange-Traded Funds," available at http://www.sec.gov/answers/etf.htm.
[33] For additional information, see "Real Estate Investment Trusts (REITs)," available at http://www.sec.gov/answers/reits.htm.
[34] For additional information, see "Investor Bulletin: Private Placements Under Regulation D," available at http://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html, and "Hedge Funds," available at http://www.sec.gov/answers/hedge.htm.
[35] For additional information, see "Investor Bulletin: Structured Notes," available at http://www.sec.gov/oiea/investor-alerts-bulletins/ib_structurednotes.html.