PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION
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June 14, 2018

Via email to pubcom@finra.org
Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-13
Quantitative Suitability

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international, not-for profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA's mission has been to promote the interests of the public investor in arbitration by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA") that govern the sales practices of brokers.

FINRA requests comment on its proposal to amend the quantitative suitability obligation under FINRA Rule 2111. Under the current rule, an investor receives the protections of the quantitative suitability obligation only when a broker exercise control over an investor's accounts. This requirement codifies case law, recognizing broker control as a necessary element to a churning claim. However, such a requirement potentially harms investors, as it forces investors to understand and determine whether the necessary level of control exists to benefit from the protection.

FINRA's suitability rule generally is premised on the notion that a broker has certain obligations before speaking and making any recommendations to investors. For example, a broker must understand the risks and rewards associated with a recommended security or strategy.[1] A broker must also have an understanding of an investor's

[1] *See* FINRA Rule 2111.05(a).

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profile to be able to determine if it is reasonable to recommend a particular security or strategy.[2] These obligations are not premised on a broker having discretion over an investor's account, nor are they dependent on the investor lacking sophistication. However, under FINRA Rule 2111, a broker must control an investor's account before the firm's supervisory structure must consider whether the quantity of transactions is suitable.[3]

When making a recommendation, a broker should have a reasonable basis for believing the recommendation is suitable for an investor, both in isolation and in the context of other recommendations made by the broker. Oftentimes, in arbitrations involving allegations of excessive trading, a broker justifies the volume of trading simply with the investor's agreement with (or failure to complain about) the transactions. All too often, brokers will argue that the pattern of trading, or the benefits that accrue to them, are irrelevant absent the improper exercise of discretion. This is contrary to the main thrust of the FINRA suitability rule: a broker should act in the best interest of the investor.[4] It is important for investor protection that the rule be amended to eliminate the necessity of control from the quantitative suitability obligation.

Further, PIABA is concerned with the following statement within the Notice:

A turnover rate of six or a cost-to-equity ratio above 20 percent generally is indicative of excessive trading. However, lower ratios have supported findings of excessive trading for customers with very conservative investment objectives, while somewhat higher ratios have not supported findings of excessive trading for some customers with highly speculative investment objectives and the financial resources to withstand potential losses.[5]

The statement implies that turnover rates of less than 6, and cost-to-equity ratios of less than 20 may be considered excessive only for customers with very conservative investment objectives. While turnover rates greater than six have generally been held to be evidence of excessive trading, rates lower than six have triggered liability for excessive trading for investors with a range of investment objectives.[6] For example, the SEC has recognized that, "for a conservative investor, an annualized turnover rate of two is suggestive, of four is presumptive, and, of six or more, is conclusive of excessive trading."[7] FINRA has found that a turnover of 3.27 was excessive for an investor with a moderate risk tolerance.[8] With respect to cost to equity ratios, rates as low as 8.7% has been found to be excessive trading.[9]

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[2] *See* FINRA Rule 2111.05(b).
[3] *See* FINRA Rule 2111.05(c).
[4] *See e.g.*, FINRA Rule 2111 (Suitability) FAQ, answer to question 7.1 ("In interpreting FINRA's suitability rule, numerous cases explicitly state that 'a broker's recommendations must be consistent with his customers' best interests.' 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."), available at https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.
[5] FINRA Regulatory Notice 18-13, 3 (April 20, 2018), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-13.pdf.
[6] *See e.g.*, *Dept. of Enforcement v. Marlboro*, 2017 WL 3142386, at *11 n.23 (excessive trading has been evidenced with turnovers as low as two).
[7] *In the Matter of Alfred M. Bauer & J. Stephen Stout*, S.E.C. Release No. 134, 68 S.E.C. Docket 2635, Release No. ID - 134, 1999 WL 4904, at *25 (Jan. 7, 1999).
[8] *Dept. of Enforcement v. Marlboro*, 2017 WL 3142386, at *13 (N.A.S.D.R. 20017).
[9] *In the Matter of the Application of Cody*, S.E.C. Release No. 64565, 2011 WL 2098202, *13 (2011).

The statement in the Notice fails to recognize the FINRA and SEC decisions which recognize much lower rates as evidence of excessive trading in accounts where there are not "very conservative" investment objectives. In fact, a cost-to-equity ratio of 20 is prohibitively high, even for the most aggressive accounts. Such an account would have to produce returns in excess of 20% just to cover the cost of investing and thereby break even. Considering the historical return for the S&P 500 is a little less than 10%,[10] a cost-to-equity ratio even approaching 10% would be excessive for nearly all investors, not just those with very conservative investment objectives.

PIABA requests that FINRA clarify the statement included in the Notice, and state that a churning analysis is unique to each investor, and that lower ratios may be excessive for investors, not only those with "very conservative investment objectives."

PIABA thanks FINRA for reviewing the quantitative suitability obligations. PIABA is supportive of the proposed amendments and looks forward to commenting on a formal rule proposal to eliminate the control element.

Respectfully submitted,

Andrew Stoltman

[10] *See* Investopedia, "What is the average annual return for the S&P 500?" ("According to historical records, the average annual return for the S&P 500 since its inception in 1928 through 2017 is approximately 10%."), available at https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp.