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June 26, 2009

Ms. Marcia E. Asquith
Office of Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

RE: FINRA Regulatory Notice 09-25
Suitability and Know Your Customer Rules

Dear Ms. Asquith:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I am pleased to comment on the above-referenced proposed changes to the Suitability Rule and the Know Your Customer Rule, FINRA Rules 2111 and 2090. PIABA generally supports this rule proposal, which arose out of the need to harmonize NASD and NYSE rules pertaining to recommendations by registered representatives to public customers. However, PIABA also believes some revisions are necessary to ensure the protection of public customers.

PIABA is a nationwide bar association comprised of attorneys who represent investors in securities arbitrations, primarily before FINRA Dispute Resolution. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities arbitration forums. Our members and their clients have a strong interest in the implementation and oversight of FINRA rules, especially those which are designed to provide critical protections to public investors. The Suitability and Know Your Customer rules exemplify the bedrock obligation of broker-dealers and their representatives to provide prudent investment advice, tailored to the needs and objectives of their clients.

PIABA Supports Proposed FINRA Rule 2111(a) Governing Suitability and the Supplementary Material Thereunder

We note first that the NASD Suitability Rule, which is current NASD Rule 2310, was specifically limited to recommendations of a "purchase, sale or exchange of any security." We applaud the new language in proposed Rule 2111(a), which requires a reasonable basis for any "recommended transaction or investment strategy." We view this language as a long-overdue clarification of the suitability obligation, which in our view recognizes the

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realities of today's financial services industry. FINRA member firms and their representatives no longer limit themselves to recommending purchases and sales of particular securities; presently, member firms and associated persons have and continue to recommend overall investment strategies. Moreover, we note that in its training for licensure, the New York Stock Exchange teaches its brokers that they have a duty to monitor a customer's portfolio and make recommendations consistent with changes in economic conditions and financial conditions as well as the customer's needs and objectives.[1] It is wholly appropriate that brokers have a reasonable basis for the overall strategy and management of a customer account, as well as for recommendations of specific securities.

We also support and appreciate the proposed rule's list of nine specific factors to be considered by a member firm in making a recommendation. This is a significant improvement over the short list of factors contained in current NASD Rule 2310(b). The rule as proposed will provide brokers with a clear road map for compiling and analyzing customer-specific information in the course of deciding what recommendations to make to the customer. It is also helpful that the rule retains the requirement that representatives take into account any other information which the member firm or representative considers to be reasonable.

We support the retention of the "fair dealing" language in Section .01 of the Supplementary Material. It is important for those persons subject to these rules to understand that the requirement of fair dealing underlies all of the specific rules, and provides the philosophical underpinning of the suitability rule in particular.

We also support the three components of suitability identified in Supplementary Material 2111.02. In particular, it is appropriate to emphasize that the suitability obligation must encompass having a reasonable basis to recommend the security in question. We support the rule clarifying that members have a due diligence requirement, and we agree that the level of required due diligence will be dependent upon the facts and circumstances of each case. The customer-specific obligation is properly identified and defined. Finally, though we have proposals below for revisions, we support the identification of "quantitative suitability" as a category of unsuitable recommendations. We believe that the term is an improvement over words previously used, such as "churning."

Finally, we support the addition of Supplementary Material 2111.03, which places the obligation on the broker to consider whether the customer

[1] Content Outline for the General Securities Registered Representative Examination (Test Series 7), New York Stock Exchange 1995.

can afford the transaction or strategy which is being recommended. This language is consistent with case law and with several published SEC decisions in disciplinary proceedings. We also agree with the point that the broker should consider whether an investment or strategy continues to be affordable. The rule change confirms the broker's duty to continue to assess the customer's financial situation.

Notwithstanding PIABA's overall support of the rule proposal, we believe that there is ample room for improvement. The next section of this letter sets forth our proposals for Rule 2111(a) and the supplementary material thereunder.

Proposed Revisions to Rule 2111 and Supplementary Material

Definition of "Recommendation"

The proposed rule noticeably lacks any definition of what constitutes a "recommendation." Member firms and their registered representatives often argue that a "recommendation" applies only to recommended purchases of securities, but not to recommendations given by brokers to hold or sell. While we believe that the insertion of the term "investment strategy" into the suitability rule goes a long way toward ameliorating this concern, we believe it would be useful to regulators and those they regulate if the rules clarified that a recommendation to "hold" is subject to the suitability rules.

As part of the Consolidated FINRA Rulebook, PIABA suggests that Proposed Rule 2111, or the supplementary material that ultimately accompanies the Rule, is the logical place to define and clarify what constitutes a "recommendation" to a customer. Neither current NASD Rule 2310 nor NYSE Rule 405, which are the subject of the current consolidation effort, clearly establishes what constitutes a "recommendation." There has been much debate over this very issue. NASD Notice to Members 96-60, issued thirteen years ago, generally states that "a broad range of circumstances may cause a transaction to be considered recommended...." A very useful definition of this important concept can be found at Incorporated NYSE Rule 472.10 /09 "Communications with the Public – Definitions", which defines a recommendation as "...any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell ***or hold*** a security" (emphasis added).

From a public customer's viewpoint, a recommendation to hold a security can have the same economic effect as a recommendation to buy or sell. By including this long-standing definition in the proposed rule, this important concept can be spelled out and provided to member firms and

public investors alike so that everyone can understand the common meaning of what constitutes a "recommendation" and ensure that the term is not defined as relating only to a recommendation to buy or sell. When a broker recommends that a customer hold a security, such recommendation must also be suitable for the customer based on all relevant factors. A broker should ascertain whether the investment remains suitable if he or she is going to recommend that a customer hold a security, as the customer's financial situation, or other relevant factors, may have changed dramatically since the time the security was purchased. Many firms argue that the definition of a recommendation contained in NYSE Rule 472 has no bearing on the suitability of their recommendations to customers, but rather relates strictly to analyst communications with the public. Now is a perfect opportunity for FINRA to clarify that the suitability rule applies to recommendations to buy, sell, or hold a security.

Examples of Unsuitable Recommendations in Current IM-2310-2

We are also concerned with the absence of language in the proposed rule mirroring current IM-2310-2 ("Fair Dealing With Customers"). IM-2310-2 contains several real-life examples of what constitutes unsuitable or fraudulent conduct. PIABA recommends that the proposed rules be expanded to include those bright-line examples, or that supplementary materials be added to the current rule to retain these provisions. In many respects, proposed Supplementary Material 2111.01-.03 overlaps current IM-2310-2 in terms of content. However, PIABA believes that the wholesale consolidation (and in some instances, deletion altogether) of the material in IM-2310-2 would be a disservice to public investors. Under the current proposal, for example, there is no specific guidance as to unauthorized transactions or recommendations to buy low-priced securities. These omissions should be rectified.

Similarly, we would like to see included in the new rule the qualification contained in IM-2310-2, that practices enumerated in the proposed rule are not all-inclusive. Any rule governing suitability should be viewed and interpreted broadly, and not in a limiting fashion.

Quantitative Suitability

PIABA is concerned with the concept that quantitative suitability applies only when a broker has actual or *de facto* control over the account. Any recommendation that is unsuitable is unsuitable, whether a broker had control over the account or not. Furthermore, the concept of "*de facto* control" requires a legal analysis, which may vary dramatically from state to state. The vast majority of brokers and their supervisors cannot be expected to

undertake this analysis on a day-to-day and account-by-account basis. We recommend that this portion of the rule be deleted.

Moreover, FINRA and the SEC have already opined that the control element is not always outcome determinative in a quantitative suitability setting, and that the suitability rule can be violated even if the "control" element is not met. As the SEC has recognized, "excessive trading represents an unsuitable frequency of trading and violates NASD suitability standards." *Paul C. Kettler*, 51 S.E.C. 30, 32 (1992); *see also Harry Gliksman*, Exchange Act Rel. No. 42255, at 4 (Dec. 20, 1999); *Michael H. Hume*, Exchange Act Rel. No. 35608, at 4 n.5 (April 17, 1995). Even in cases where a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. *See Rafael Pinchas*, Exchange Act Rel. No. 41816, at 11 (Sept. 1, 1999) (customer's desire to "double her money" does not relieve registered representative of duty to recommend only suitable investments); *see also John M. Reynolds*, 50 S.E.C. 805, 809 (1992) (regardless of whether the customers wanted to engage in aggressive and speculative trading, the representative was obligated to abstain from making recommendations that were inconsistent with their financial situation).

Thus, if a customer wishes to trade beyond his means or in such a way that makes it almost impossible to cover the costs of the account, the customer should be notified of that fact. Under the proposed rule, the broker would be permitted to stand on the sidelines and turn a blind eye to the trading activity under the guise that she was not controlling the account. Such a concept is at direct odds with FINRA's stated commitment to protecting investors.

PIABA Favors Greater Documentation of the Suitability Exemptions for Institutional Investors

PIABA is concerned with the portion of the proposed revisions that would seek to eliminate and/or substantially reduce the express suitability obligations that are applicable to institutional investors under IM-2310-3.

Under the proposed revision that has been presented for consideration in Rule 2111(b), an institutional investor would potentially lose all of the suitability protections that presently exist if certain "clear exemptions" were applicable, including, but not limited to, if the institutional investor were to "affirmatively indicate" that it was "willing to forego the protection of the customer-specific obligation of the suitability rule."

There is no discussion, however, as to whether this "affirmative" indication would need to be evidenced in a written document that the institutional customer would be required to sign or as to whether any specific disclosures of the material terms and conditions that are associated with the waiver of the suitability protection rule would be required to be evidenced in a written document that the member or associated person would be required to provide to the institutional customer. This kind of "waiver," if appropriate at all, simply cannot be accomplished by boilerplate contractual terms.

Accordingly, we would recommend that proposed Rule 2111(b) be amended so as to require that: (a) the "affirmative" indication to be made by an institutional customer would be evidenced in a written document that the institutional customer would sign; and (b) that, in connection with the same, the disclosures of the material terms and conditions that are associated with the waiver of the suitability rule's protections would be evidenced in a written document that the member or associated person would provide to the institutional customer.

PIABA Supports Retention of the "Know Your Customer" Rule

We are gratified to see that FINRA intends to retain the iconic "Know Your Customer" Rule, formerly set forth in NYSE Rule 405. We have always felt that the Know Your Customer Rule goes beyond the FINRA Suitability Rule, so we are pleased to see that the crux of the rule appears in proposed Rule 2090. While we have some important suggestions for this Rule, we wish to state our support for the Rule's inclusion in the consolidated handbook.

One of the key components of this Rule is that it applies without regard to the need for a "recommendation." In the Regulatory Notice, FINRA recognized that this is an obligation which arises at the outset of the parties' relationship, without regard to whether a recommendation has occurred.

We also note with approval that a member firm is not only required to "know" the essential facts about a customer, but is required to "retain" that information. We have some concern that there is no requirement of written documentation or substantiation in the Rule; however, we trust that this issue will be covered in other rule changes or by reference to the existing SEC Rules regarding document retention.

Proposed Revisions to Rule 2090

Noticeably absent in proposed Rule 2090 is language from current NYSE Rule 405 that requires a broker to use due diligence to learn the essential facts relative "every order, every cash or margin account," in

addition to the information relating to the customer. Rather, the proposed Rule would limit the member's obligation to learning about the customer. This would appear to shrink the due diligence obligations of the member firm to a marked degree. We are troubled by the omission of this language, and we hope FINRA will consider reinserting the language from the original Rule 405.

We are especially concerned about the omission of an important word in transforming NYSE Rule 405 into FINRA Rule 2090. Rule 405 requires firms to know essential facts relating to every "order." Owing to the use of the word "order" the NYSE Rule recognizes the obligation of a firm to not only "Know Your Customer," but to "Know Your Security." There should not be room for anyone to argue that the latter duty has been diminished by the rule change, particularly at a time when the complexity of investment products challenges even the most "sophisticated" customers.

We also note that the current version of NYSE Rule 405 requires a member firm to learn the essential facts relative to "every person holding a power of attorney over any account" carried by the firm. In short, the current rule requires the firm to "know the customer's agent" as well as to know the customer. The new Rule again curtails the firm's due diligence obligations, by limiting the firm's obligation to learn the essential facts about *the authority* of any person acting on behalf of the customer. We would be sorry to see the firm's due diligence obligations lessened in this manner. We hope FINRA will consider reinstating the member firm's obligation to "know the agent" as well as the customer.

Finally, proposed Rule 2090 is unclear about exactly who has the due diligence obligations. Former Rule 405 makes it clear that the member firm is required to exercise these due diligence obligations through an officer or compliance official. We are very concerned that firms will use the proposed Rule to take the position that the broker's attempt to learn the essential facts about a customer is enough. This is a serious contraction of the firm's management and supervisorial obligations, and one which we doubt FINRA intends. Therefore, we suggest that the rule be revised, or that supplementary material be added, to clarify that the firm can only carry out these due diligence requirements through an officer or compliance professional.

Conclusion

We are greatly encouraged by FINRA's proposed rules, although we believe that there is significant room for improvement. We urge FINRA to file these rule proposals with the SEC, after adopting the recommendations set

forth in this letter. FINRA's mission of providing investor protection will best be served by the proposed revisions.

Please do not hesitate to contact me should you desire further discussion of the above. Thank you for your courtesy.

Respectfully,

PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

Brian N. Smiley
President