

New Finra suitability rule worries B-Ds

By [Dan Jamieson](#) InvestmentNews
July 8, 2012

A major overhaul of suitability mandates that take effect today has some in the broker-dealer world worried about much broader obligations to oversee customer accounts and investment strategies.

Of particular note is a provision that requires brokers to perform reasonable diligence on products, understand those investments and have a reasonable basis to think that a security or investment strategy is suitable. It also adds the investor's age, investment experience, time horizon, liquidity needs and risk tolerance to the list of factors that affect a suitability determination.

The rule follows guidance that the Financial Industry Regulatory Authority Inc. issued in late May. That guidance is seen by some as coming awfully close to a fiduciary standard for broker-dealers and registered representatives.

Perhaps of most concern to broker-dealers, the rule imposes suitability obligations on investment strategies.

In its rule filing, Finra said that the term "investment strategy" would be interpreted broadly and cover a recommendation to "hold" an investment, as well as a "buy" or "sell" recommendation.

The Securities and Exchange Commission approved the rule in November 2010. Implementation was delayed until today to give the industry time to prepare.

The May guidance from Finra (Regulatory Notice 12-25) laid out a "best interests" standard of care for customers. The notice also said that the new suitability rule would apply to "potential" customers and to non-security "investment-related" products.

The notice "was surprising to us and some of our [brokerage] clients, coming so quickly before the implementation was to occur," said W. Hardy Callcott, a law partner at Bingham McCutchen LLP.

BACK TO SQUARE ONE

"It has caused people to go back to the drawing board on some of the training" that they had developed for registered reps, he said.

The best-interests standard in particular caught some off guard, as the SEC is working on developing a fiduciary standard under the Dodd-Frank Act.

"Usually, when you talk about a fiduciary duty, 'best interests' is the standard you use," said Brian Rubin, a partner at Sutherland Asbill & Brennan LLP.

"NOT A NEW STANDARD"

Mr. Callcott thinks that Finra is trying to get a jump on overseeing a fiduciary duty in an attempt to bolster its case for getting oversight of advisers.

For its part, Finra said that most of the changes in the new suitability rule simply codify case law and past interpretations.

“The requirement that a broker's recommendations be consistent with the customer's best interests is not a new standard,” Finra spokeswoman Michelle Ong wrote in an e-mail.

Regarding a best-interests standard, Finra cited a number of enforcement cases that have held that brokers' recommendations must be consistent with clients' best interests.

“Despite what Finra says, I do not think that is what has been the Finra standard,” Mr. Callcott said. “They should have proposed [the best-interests standard] as part of the rule change.”

The rule itself doesn't mention such a standard, so brokers are still obligated only to make suitable recommendations, said Joel Beck, founder of The Beck Law Firm LLC.

Still, “best interest is rather subjective,” he said.

In its notice, Finra said that a best-interests standard doesn't mean that brokers have to sell only the lowest-cost product.

The latest notice “seems like a bit of jurisdiction creep,” said Lisa Roth, chief executive of Keystone Capital Corp.

“It gets fuzzy when you get into issues of where you get the money” to buy a non-security, said Gary Sanders, vice president of securities and state government affairs for the National Association of Insurance and Financial Advisors.

But tracking sources of funds used to purchase securities always has been part of the suitability rule, he said.

The impending changes have caused broker-dealers to scramble to figure out how to oversee various strategies and document the supervisory process.

"COCKTAIL PARTY' RULE

The most challenging issue is defining and tracking what strategies a rep is recommending, observers said, including recommendations to hold an investment that aren't recorded in any trade records.

“You've got to understand what the overall [customer] profile and strategy is, and where [the specific] account fits into it,” Ms. Roth said.

A good example of that uncertainty is figuring out exactly to whom the rule applies, now that potential clients are covered, Mr. Callcott said.

“It's the “cocktail party' rule, as I call it, where you have a conversation with someone,” he said. “That could be a recommendation you have to capture in the firm's system.”

Despite the uncertainty over the new rule, Mr. Rubin said that it is unlikely that Finra will take any immediate enforcement action against firms that have made an effort to comply.

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