

FINRA Issues Notice To Members Discussing Examination Findings Regarding the Revised Suitability Requirements

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As the second anniversary of FINRA Rule 2111 rule approaches, FINRA has issued Regulatory Notice to Members 13-31 (the “**Notice**”) summarizing its observations from examinations of firm compliance with the new rule. While the Notice does not alter the rule or provide new guidance, it offers some interesting insights into FINRA’s approach to those examinations and its views relating to compliance with the new suitability requirements, including identifying effective compliance practices.

Background

FINRA’s suitability rule became effective on October 7, 2011. While it maintained many of the same requirements of the prior rule (NASD Rule 2310), it introduced some significant changes, including broadening the rule to specifically cover recommended investment strategies (including explicit recommendations to “hold” a security) and modifying the institutional-investor exemption in a number of important ways.

General Examination Findings

In the Notice, FINRA notes that because the suitability rule amendments are still relatively new, many firms have not yet had a completed cycle examination. Of the firms examined, however, FINRA examiners found that most had updated policies, procedures and systems to address the new suitability requirements. Among firms where FINRA found deficiencies, inadequate procedures for hold recommendations (e.g., how the firm supervises and, when necessary, documents such hold recommendations) were the most frequent deficiencies. FINRA states that most of these deficiencies were addressed through a “Cautionary Action” that cited firms for inadequate supervisory procedures. FINRA will consider, however, formal disciplinary action for more serious violations when appropriate, such as cases involving unsuitable recommendations. FINRA notes that the few examination findings that have already resulted in referrals to the FINRA Enforcement Department involved suitability violations that were actionable under the predecessor suitability rule.

Examination Approach

The Notice states that examinations for suitability compliance would typically begin with an analysis of a firm’s controls, largely through interviewing principals responsible for preparing the firm’s suitability policies and procedures, and considering the products the firm sells and the types of customers with which the firm conducts business. In addition, the Notice provides examples of the types of questions and information requests that can be expected in these examinations, including information about a firm’s readiness to control risks related to suitability. The examination would generally include assessment of:

- the firm’s training on suitability issues, including whether the training covers investment strategies and hold recommendations;
- the firm’s supervisory and compliance procedures for reasonable-basis, customer-specific and quantitative suitability;
- the firm’s tools, such as exception reports, to identify in-and-out trading and high turnover rates and commission-equity ratios; and
- to the extent a firm uses portfolio analytic tools or models, how the firm determines whether the tools or models make recommendations subject to the suitability rule.

FINRA examiners would then conduct a review of the internal firm controls to determine whether firm procedures are followed, with a particular focus on “red flag” transactions, including where the same security is held in the account or strategy implemented for multiple investors of a particular representative despite differing customer profiles.

Observations of Effective Compliance Practices

Acknowledging that the relevance and feasibility of particular practices vary widely depending on factors such as a firm’s size, business model, products offered and customer base, the Notice highlights various examples of effective practices at firms relating to:

- new product vetting processes;
- product-focused trainings;
- technology-based tools for capturing and accessing customer profile data required for customer-specific suitability analyses; and
- systems for categorizing customers by specific suitability profiles or flagging vulnerable investors.

Of particular interest are FINRA observations regarding “hold” and other investment strategy recommendations. FINRA observed the following effective practices:

- systems that have a “hold ticket” or a “hold blotter” that captures hold strategy recommendations;
- systems that capture notes of discussions with clients regarding explicit hold or other strategy recommendations by associated persons maintained in customer files;
- firm branch office inspections that focus on the documentation of hold and other strategy conversations with clients;
- modified new account forms that list specific investment strategies, and that require the associated person to identify on the form any that are recommended at the time of account opening;
- account forms that require signature by the customer when associated persons recommend changes to a previously recommended account investment strategy; and
- a prohibition on associated persons engaging firm clients in the associated persons’ outside business activities.

[See a copy of the full FINRA Notice >](#)

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Annette L. Nazareth

+1 202 962 7075

annette.nazareth@davispolk.com

Zachary J. Zweihorn

+1 202 962 7136

zachary.zweihorn@davispolk.com

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