



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
INVESTOR ADVOCATE

June 19, 2018

Submitted Electronically (pubcom@finra.org)

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 18-13, Quantitative Suitability

Dear Ms. Mitchell:

The Office of the Investor Advocate¹ at the Securities and Exchange Commission (“Commission” or “SEC”) appreciates this opportunity to provide comments in regard to the issues raised in the Financial Industry Regulatory Authority, Inc.’s (“FINRA”) Regulatory Notice 18-13 (the “Notice”).² The Office of the Investor Advocate has a strong interest in potential rule changes involving FINRA’s supervision of broker-dealer conduct, and particularly the rules that promote fair dealing and ethical sales practices, because they play such a key role in protecting retail investors.

I. Introduction

The Notice describes a potential change to what FINRA must prove to demonstrate that a broker-dealer has violated its quantitative suitability obligation, sometimes described as a prohibition on excessive trading or “churning.” The proposal would amend FINRA’s Rule 2111, which imposes general suitability obligations on all broker recommendations for particular transactions and investment strategies.³ Currently, to demonstrate that a broker has violated its quantitative suitability obligation, FINRA must prove: (1) an element of control over the customer’s account by the broker; (2) that the transactions were recommended by the broker; and (3) that the level of trading was excessive and unsuitable in light of the customer’s investment profile.⁴ Based on its experience with this rule in

¹ Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934, 15 U.S.C. § 78d(g)(4) (2012), the Office of the Investor Advocate at the Securities and Exchange Commission is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations. In furtherance of this objective, we routinely review and examine the impact on investors of proposed rulemakings of SROs, including those issued by FINRA, and make recommendations to the SROs proposing those rulemakings. As appropriate, we make formal recommendations and/or utilize the public comment process to help ensure that the interests of investors are fully considered as rules are adopted.

² FINRA, REG. NOTICE 18-13, QUANTITATIVE SUITABILITY (Apr. 20, 2018), <http://www.finra.org/industry/notices/18-13> [hereinafter NOTICE 18-13].

³ See generally FINRA Rule 2111 (2012), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

⁴ See NOTICE 18-13, *supra* note 2, at 1.

practice, FINRA is considering removing the requirement that it prove a level of control in order to find a violation.⁵

The Office of the Investor Advocate has reviewed the Notice and the comments received to date. In brief, we believe that FINRA would be well served by the change, which would allow it to better protect the interests of retail investors by holding brokers responsible for recommendations that result in excessive trading. In addition, the proposed change will serve as a deterrent to possible future misconduct. We support the proposed amendments, and we encourage FINRA to adopt them.

II. Background

FINRA Rule 2111 (Suitability) imposes three main suitability obligations on broker-dealers when making a recommendation to a customer for a particular transaction or investment strategy: (1) reasonable-basis suitability; (2) customer-specific suitability; and (3) quantitative suitability.⁶ The first requires a broker to have a reasonable basis to believe, based on reasonable diligence, that a recommendation is suitable for at least some investors.⁷ The second requires a broker, based on a particular customer's investment profile,⁸ to have a reasonable basis to believe that the recommendation is suitable for that particular customer.⁹ Together, these first two requirements make clear that a broker must have a firm understanding of both the product and the customer.

The third obligation, relevant here, currently requires a broker who has control, actual or de facto, over a customer account to have a reasonable basis for believing that a *series* of recommended transactions, even if each might be suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.¹⁰ In initially drafting the rule text earlier this decade, FINRA sought to codify a line of existing cases on excessive trading or "churning."¹¹

As described in the Notice, under the case law, *actual* control exists when a broker has formal discretionary authority over a customer's account, whereas a showing of *de facto* control over a customer's account depends on whether the customer routinely follows the broker's advice because the customer is unable to evaluate the broker's recommendation and exercise independent judgment.¹² FINRA suggests that, in practice, an assessment of de facto control can be difficult to make and places a heavy and unnecessary burden on customers by, in effect, asking them to admit that they lack

⁵ See *id.*

⁶ See FINRA Rule 2111, *supra* note 3, at Supplementary Material .05, Components of Suitability Obligation.

⁷ See FINRA Rule 2111, Supp. Material .05(a).

⁸ See FINRA Rule 2111(a), which notes 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 See FINRA Rule 2111, Supp. Material .05(b).

¹⁰ See FINRA Rule 2111, Supp. Material .05(c).

¹¹ See FINRA Regulatory Notice 12-25, at 14 (May 2012),

<http://www.finra.org/sites/default/files/NoticeDocument/p126431.pdf>, ("The quantitative suitability obligation under the new rule simply codifies excessive trading cases").

¹² See NOTICE 18-13, *supra* note 2, at 2.

sophistication or the ability to evaluate their broker's recommendation.¹³ FINRA is proposing to remove the element of control that currently must be proved to demonstrate a violation, but is not otherwise proposing to change the existing standard involving excessive trading.

III. Analysis

The Securities Exchange Act of 1934 requires that the rules of a registered securities association such as FINRA be designed, in relevant part, to protect investors and the public interest.¹⁴ Here, FINRA is proposing to remove the control element from the quantitative suitability obligation, while retaining the requirements that FINRA demonstrate both that the transactions were recommended by the broker and that the level of trading was excessive and unsuitable in light of the customer's investment profile.

As described in the Notice, the inclusion of the control element had historic roots, in part, in the perceived need to ensure that the culpability for excessive trading rested with the party responsible for initiating the transactions in proceedings brought pursuant to the antifraud provisions of the federal securities laws.¹⁵ FINRA argues that requiring the control element is unnecessary under the quantitative suitability rule. In essence, FINRA Rule 2111 already ensures that FINRA will only be able to punish the responsible party, as FINRA is required to show that the broker *recommended* the transaction. Therefore, regulatory culpability still rests with the appropriate party, even absent the control element.¹⁶

In my experience, which includes 15 years of handling enforcement actions against broker-dealer firms and registered representatives, "bad" brokers make money in two general ways: (1) they sell a bad product to a lot of people; or (2) they get a customer to trade frequently. I am quite familiar with the elements required to prove excessive trading, and I agree with the concern expressed by FINRA in the Notice that the control element serves as "an impediment to investor protection and an unwarranted defense to unscrupulous brokers." Churning is often difficult to prove because the victim unwittingly consents to the trading, not understanding the full import of the trading strategy, which can undermine the control element. Egregious cases can then go unpunished.

This kind of rule change would go a long way to deterring this type of abusive practice. The proposed amendments will provide a self-regulatory body with a more appropriate way to police its members and thereby protect vulnerable investors. At the same time, FINRA will still be required to prove that the series of recommended transactions was excessive and unsuitable. Investors will still be free to trade as often as they want, but professionals would be required to consider whether it is appropriate to recommend such a strategy.

As to the Notice's Question 4, concerning the material economic impacts of the proposed change, including its potential costs and benefits,¹⁷ we suggest that FINRA review its own disciplinary actions against churning brokers. We are confident this would show that the proposed rule change, by both enhancing deterrence and punishing "bad" brokers, would significantly benefit investors. These

¹³ See NOTICE 18-13, *supra* note 2, at 1.

¹⁴ See 15 U.S.C. § 78o-3(b)(6) (2010).

¹⁵ See NOTICE 18-13, *supra* note 2, at 3.

¹⁶ See *id.*


¹⁷ See NOTICE 18-13, *supra* note 2, at 5.

types of cases highlight the harm caused by churning, where a broker may seek to generate thousands of dollars in commissions and, at the same time, the excessive trading results in thousands of dollars of customer losses.¹⁸ For example, just this past fall, FINRA's hearing panel ordered a broker to pay more than \$155,000 in restitution to a blind, elderly widow who was harmed by, in part, the broker's practice of frequently buying and selling securities within a week or two, engaging in more than 700 trades over a three year period and paying approximately \$210,000 in commissions while losing more than \$175,000 in her account.¹⁹

IV. Conclusion

We commend FINRA for proposing changes that should directly benefit retail investors by both improving FINRA's ability to punish churning brokers and sending a message that should deter it. We are completely supportive of the proposed change contained in the Notice and encourage FINRA, after reviewing all the comments, to move quickly in seeking Commission approval for its proposed rule change.

Should you have any questions, please do not hesitate to contact me or Senior Trading and Markets Counsel Adam Moore at (202) 551-3302.



Rick A. Fleming
Investor Advocate

¹⁸ See, e.g., FINRA News Release, FINRA Bars Former CISC Broker for Churning Customer Accounts (Aug. 6, 2015), <http://www.finra.org/newsroom/2015/finra-bars-former-cisc-broker-churning-customer-accounts>.

¹⁹ See FINRA News Release, FINRA Hearing Panel Bars Broker for Defrauding Elderly, Blind Customer (Nov. 9, 2017), <http://www.finra.org/newsroom/2017/finra-hearing-panel-bars-broker-defrauding-elderly-blind-customer>; http://www.finra.org/sites/default/files/Werner_Extended_Hearing_Panel_Decision_110917.pdf.