September 14, 2010

VIA ELECTRONIC MAIL (rule-comments@sec.gov)

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Release No. 34-62718; File No. SR-FINRA-2010-39; Proposed Know Your Customer and Suitability Rules

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the referenced proposal, in which FINRA seeks the Securities and Exchange Commission's ("SEC") approval to adopt FINRA Rules 2090 and 2111 and related Supplementary Material governing member firms' "Know Your Customer" and Suitability obligations, respectively.[2] Proposed FINRA Rules 2090 and 2111 effectively would replace existing NASD Rule 2310 and Incorporated NYSE Rule 405 and much of the interpretive materials accompanying such rules.

SIFMA greatly appreciates FINRA's willingness to consider the issues raised by SIFMA and other industry commenters in response to Regulatory Notice 09-25 (May 2009) (the "Notice"), through which FINRA sought comment on its original proposal.

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[1] The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). For more information, visit www.sifma.org.

[2] Securities Exchange Act Release No. 62718 (August 13, 2010), 75 Federal Register 51310 (August 19, 2010) (hereinafter, the "Proposal").

While SIFMA generally supports the goals of the Proposal, we suggest that the SEC consider the Proposal as part of its comprehensive study regarding the effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers (the "Study"). In addition, for the reasons discussed below, we strongly recommend clarifying potentially problematic language in proposed Supplemental Material .05 to Rule 2111 and respectfully request a number of other refinements to the Proposal.

I. Relationship to Fiduciary Standard of Care

Although FINRA maintains that application of a suitability standard is not inconsistent with a fiduciary standard, we strongly believe that the SEC should consider FINRA's Proposal as part of the Study. Any review of the effectiveness of existing legal or regulatory standards of care for broker-dealers necessarily must take into account suitability rules. Approaching these issues in a piecemeal manner could result in inconsistent application and confusion in the industry and, depending on the results of the Study, unnecessarily subject customers to changing standards. In particular, implementation of proposed FINRA Rules 2090 and 2111 would have significant systems implications, impose new record-keeping requirements and result in substantial implementation efforts that may well be undone or create investor confusion if the SEC later adopts new rules or an overarching standard of care requiring additional or different information from that required by proposed Rules 2090 and 2111. Given that the Study is already underway and likely to be completed in the near term, we submit that existing NASD and NYSE suitability rules are sufficient to protect investors in the interim.

II. Institutional Customer Accounts

We appreciate that FINRA has now eliminated the proposed requirement that institutional customers affirmatively opt-out of customer-specific suitability protections, as this would have effectively eliminated the institutional exemption in practice. SIFMA strongly recommends, however, that FINRA clarify new Supplementary Material .05 because it is confusing as currently drafted.

Proposed FINRA Rule 2111(b) now provides that a member or associated person fulfills the customer-specific suitability obligation for an institutional account if "(1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer *affirmatively indicates* that it is exercising independent judgment in evaluating the member's or associated person's recommendations (emphasis added)." In addition, FINRA has proposed new Supplementary Material .05, "Institutional Investor," which provides: "[w]ith respect to having to indicate affirmatively that it is

exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account."

As currently drafted, Supplementary Material .05 is confusing and subject to varying interpretations. We believe that the intent of Supplementary Material .05 is to clarify that proposed Rule 2111(b)(2) allows member firms to establish and document a clear understanding of the institutional customer's independence at the outset of the relationship – that is, at the time of account opening. This reading would be consistent with the overall needs of the institutional client base, which values flexibility and speed of execution. It would also be consistent with other arrangements pursuant to SRO rules.[3] If we are correct that this is FINRA's intent,[4] we respectfully submit that Supplementary Material .05 could be much more clearly and simply worded as:

> "**.05 Institutional Customer.** For purposes of Rule 2111(b)(2), the member or associated person may obtain the affirmative indication that an institutional customer is exercising independent judgment in evaluating the member's or associated person's recommendations with respect to all potential transactions for such customer's account."

In suggesting the foregoing clarification of proposed Supplementary Material .05, SIFMA acknowledges that, notwithstanding the affirmative indication required under proposed Rule 2111(b)(2), member firms must continue to meet their obligations under proposed Rule 2111(b)(1). Moreover, an institutional customer at any time would be able to revoke or amend its initial affirmative indication under proposed Rule 2111(b)(2) that it is exercising independent judgment as to all potential transactions. SIFMA believes, however, that many institutional customers in practice will seek to represent whether they

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[3] *See*, for example, NASD Rule 2510(b) and Proposed FINRA Rule 3260(b) (requiring members to obtain consent from a client prior to exercising discretion in that client's account); Incorporated NYSE Rule 402 and Proposed FINRA Rule 4330(b) (permitting members to use a single margin/loan consent agreement as written authorization to permit the loaning of a customer's margin-eligible securities).

[4] We note that, if FINRA intends in Supplementary Material .05 to give institutional customers the ability to require member firms to capture changing affirmative indications on a trade-by-trade basis, the provision will fundamentally alter the operation of the institutional markets and could have a negative impact on execution quality. In fast moving markets, requiring firms to obtain and document affirmative indications on a trade-by-trade basis could result in missed execution opportunities, to the detriment of best execution. A "check the box" requirement would be particularly detrimental to electronic trading, where stopping a trade to ensure that an affirmation has been received would result in the customer missing the market. This in turn could lead to unnecessary misunderstandings or disputes with institutional customers. If this is FINRA's intent, we would very much appreciate the opportunity for a meeting to discuss the impact on the institutional markets.

are exercising independent judgment (or not) with respect to all transactions for specific accounts over which they exercise investment discretion.

In addition, we request that not all institutional customers be required to provide the "affirmative indication" required by proposed Rule 2111(b). In particular, SIFMA would propose that those institutional investors that qualify as qualified institutional buyers ("QIBs") for purposes of SEC Rule 144A should not be required to provide this proposed affirmative indication.[5] These customers are among the most sophisticated counterparties in the institutional marketplace, and member firms already have well established suitability procedures for these customers that reflect their level of sophistication.

Finally, SIFMA believes that proposed Rule 2111(b) should be expanded to make clear that, in addition to meeting its customer-specific suitability obligation, a member firm also meets its quantitative suitability obligation if the conditions in Rule 2111(b)(1) and (2) are satisfied.[6] Imposing a quantitative suitability obligation in the institutional DVP/RVP context makes little sense. Because institutions typically have their own internal portfolio managers, handle custody away from the broker-dealer and execute trades with multiple firms, no single firm is in a position to determine whether the institution's transactions are so excessive or frequent as to constitute churning. No one firm is seeing all the trades, nor is any one firm seeing the institution's entire investment portfolio, because they do not maintain custody of all assets.

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[5] For purposes of Rule 144A an entity generally meets the QIB definition if it owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity.

[6] We note here a few unusual aspects in the drafting of proposed Rule 2111, titled "Suitability." Proposed Rule 2111(a) clearly addresses "customer-specific" suitability obligations (despite the use of the "reasonable basis" phrase in the rule, it addresses the per customer requirement). Proposed Rule 2111(b) interprets that suitability standard in the context of institutional accounts. However, it is in Supplementary Material .03 – and only in this section – that the three components of suitability are noted (*i.e.*, the "reasonable-basis" obligation, the "customer-specific" obligation," and "quantitative" suitability. The issue discussed in this sub-section of our letter largely arises from the lack of clarity around how one element of the Supplementary Material apply to these two other suitability concepts. There are other examples, such as Supplementary Material .04, as it may apply to quantitative suitability. FINRA could consider making the relationship among these standards clearer by stating in the text of the Rule itself the different types of suitability standards firms must meet.

Additionally, we note that certain terminology in the Rule seems inconsistent, perhaps inadvertently so. For example, Rule 2111(a) on customer-specific suitability requires "reasonable diligence" in ascertaining a customer's investment profile, while Supplementary Material .03(b) uses "reasonable grounds" and Supplementary Material .03(a), for reasonable basis suitability, uses "adequate due diligence." The impact of these difference is uncertain, but FINRA could consider limiting the uncertainty by utilizing consistent terms, if, in fact, the standard is intended to be consistent.

III. Enumerated Suitability Elements

The Proposal expands the explicit list of data elements that member firms and associated persons must attempt to gather and analyze. In particular, proposed FINRA Rule 2111(a) would expand the categories of information to include the customer's age, investment experience, investment time horizon, liquidity needs, and risk tolerance.

SIFMA renews its comments from its letter in response to the Notice that, when making recommendations, firms should not be required in all cases to obtain information related to each of the enumerated data elements in proposed Rule 2111(a), but rather should have the flexibility to focus on the factors that are relevant to the suitability determination at issue. Such flexibility is particularly appropriate given that certain data elements simply will not apply in all cases (*e.g.*, the customer's "age" in the context of non-natural person accounts). In addition, we are concerned that an inflexible set of factors will lead to a static or formulaic approach that could detract from firms' development of more dynamic and individualized approaches to suitability determinations.

SIFMA also believes that the description of the data elements as "the customer's investment profile" is potentially confusing in light of the fact that some of the new elements are account-specific, rather than customer-specific. For example, a single retail customer may maintain several different accounts with the same firm, and each account may have a different time horizon and/or risk tolerance. In light of the above concerns, we recommend that proposed Rule 2111(a) be modified slightly, as follows:

> (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile, including, but not limited to, **the following factors as applicable to the relevant customer, the customer's specific account, and the proposed transaction:** 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 (proposed new language is in bold font).

Finally, although we agree that members must be sensitive to customers' liquidity needs, SIFMA questions the value of isolating "liquidity needs" as an independent suitability factor. As we understand the concept of liquidity needs in this context, it is simply one component of a customer's overall financial situation. Read literally, "liquidity needs" could conceivably include a customer's household expenses and thus extend far beyond reasonable questions about the customer's income and assets when formulating suitable

investment recommendations. Accordingly, SIFMA recommends that the term "liquidity needs" be deleted from Rule 2111. In the alternative, if FINRA retains "liquidity needs" as a mandatory data element, then we recommend that FINRA add the words "in relation to other relevant suitability factors and the products or services being recommended," so that FINRA's expectations are more clear.

IV Know Your Customer Rule

Although SIFMA generally supports proposed FINRA Rule 2090, we are concerned that FINRA has proposed to eliminate, along with current NYSE Rule 405, Supplementary Material .20, which effectively sanctions the use of clearing agreements to allocate responsibility between introducing and clearing firms for "Know Your Customer" and account approval purposes. SIFMA respectfully requests that the substance of this provision remain in force and be added as Supplementary Material .02 to proposed FINRA Rule 2090.

V. Implementation Issues

Finally, SIFMA renews its request for an appropriate period of implementation in light of the pervasive scope of the Rules. Firms will need a significant amount of time to modify account opening and retention systems, amend attendant forms, and collect the new suitability information for existing clients who receive recommendations after the effective date of the Rules.

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SIFMA appreciates the opportunity to provide comments on the Proposal. We would be pleased to discuss the proposed Rules and our comments in greater detail with the SEC and its staff. If you have any comments or questions, please do not hesitate to contact me at 202-962-7386 or jmchale@sifma.org.

Sincerely,

/s/ James T. McHale

James T. McHale
Managing Director and Associate General Counsel
SIFMA

cc: Ms. Lourdes Gonzales