FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT BROKER-DEALERS
AND INDEPENDENT FINANCIAL ADVISORS

www.financialservices.org

VIA ELECTRONIC MAIL

September 27, 2010

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

RE: File Number SR-FINRA-2010-039 – Proposed Rule Change To Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook

Dear Ms. Murphy:

On August 13, 2010, the Financial Industry Regulatory Authority (FINRA) proposed the adoption of Rule 2090 (Suitability Rule) and Rule 2111 (Know Your Customer Rule) as part of the Consolidate Rulebook (Proposed Rules).[1] The Proposed Rules would combine the terms of NASD Rule 2310, addressing suitability obligations, and Incorporated NYSE Rule 405, addressing know-your-customer obligations, into a single rule as part of the Consolidated FINRA Rulebook and replace the existing NYSE and NASD Rules and related interpretative material.[2] In addition, the Proposed Rules would codify various interpretations regarding the scope of the suitability rule, clarify the information to be gathered and considered as part of a suitability analysis, and create an exemption for recommended transactions involving institutional customers, subject to specified conditions.

The Financial Services Institute (FSI)[3] welcomes this opportunity to comment on the Proposed Rules. FSI previously submitted a comment letter in response to Regulatory Notice 09-25[4], which originally set forth FINRA's proposed rules related to suitability and "Know Your Customer", and are pleased that FINRA addressed many of the concerns we raised. Specifically, we note that FINRA:

- Chose not to apply the suitability requirements to non-security investment products. We applaud this decision because such an effort would result in redundant, conflicting, and contradictory regulatory requirements that do not advance the goal of investor protection; and
- Amended the Suitability Rule to remove the proposed requirement that the suitability determination include an examination of information known to the broker-dealer. We

[1] SEC Release NO. 34-62718.
[2] The proposed rule change would delete NASD Rule 2310, IM–2310–1 (Possible Application of SEC Rules 15g–1 through 15g–9), IM–2310–2 (Fair Dealing with Customers), IM–2310–3 (Suitability Obligations to Institutional Customers), NYSE Rule 405(1) through (3) (including NYSE Supplementary Material 405.10 through .30), and NYSE Rule Interpretations 405/01 through/04.
[3] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 123 Broker-Dealer member firms that have more than 188,000 affiliated registered representatives serving more than 15 million American households. FSI also has more than 14,500 Financial Advisor members.
[4] Regulatory Notice 09-25, Suitability and "Know Your Customer", available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118709.pdf.

support this decision because we believe such a requirement is simply unworkable and unlikely to result in significant improvements in investor protection.

Despite these improvements, we remain concerned with several aspects of the Proposed Rules. These concerns are addressed in detail below.

Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors that affiliate with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees, of their affiliated broker-dealer firm.[5] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[6] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

---

[5] Cerulli Associates at http://www.cerulli.com/.

[6] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

Comments on the Proposed Rule

As stated above, FSI remains concerned with several aspects of the Proposed Rules. These concerns are addressed below.

- **Proposed Rules are Being Considered Prematurely –** FINRA is currently engaged in the process of integrating the existing NASD and NYSE rules into a consolidated rulebook. This is an important project with wide reaching implications. It is, however, only one small part of the current debate surrounding the financial services regulatory structure. An important issue in this debate is the standard of care owed by a financial advisor to a client. On July 27, the Securities and Exchange Commission (SEC) published a request for public comment related to its study of the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors (Study). The Study is required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),[7] which President Obama signed into law on July 21, 2010. As required by the Dodd-Frank Act, the SEC is requesting public input, comment, and data on issues related to the effectiveness of existing standards of care for brokers, dealers, and investment advisers, and whether there are gaps, shortcomings, or overlaps in the current legal or regulatory standards.

  The Study, and the SEC rulemaking that will surely follow, have the potential to make the Proposed Rules a moot point or, at the very least, alter their implications substantially. Therefore, we urge a delay in the adoption of the Proposed Rules while we await clarity on the broader standard of care issue. Such an approach will reduce the cost and confusion inherent in making two significant and fundamental changes to this foundational principle within a relatively short period of time.

- **Suitability Rule Inappropriately Expanded to Include Portfolio Level Concerns –** The proposed Suitability Rule expands the information that must be analyzed in determining whether a recommendation is suitable for a client to include the following additional criteria:

  - Client's age,
  - Other investments,
  - Investment experience,
  - Investment time horizon,
  - Liquidity needs, and
  - Risk tolerance.

  We believe that a client's investment time horizon, liquidity needs, and risk tolerance are important considerations that must be judged at the portfolio level. However, the Suitability Rule would appear to require each securities transaction to be suitable based upon these additional criteria. FINRA noted this concern in the proposing release. However, they chose not to amend the proposed Suitability Rule to address the concern, nor explain their basis for leaving it unchanged.

  We believe the proposed Suitability Rule would have unfortunate unintended consequences for investors who may have several competing investment objectives that are best met by a fully diversified portfolio made up of securities of varying degrees of liquidity, risk, and anticipated holding periods. As a result, we again ask FINRA to clarify

[7] Public Law No: 111-20, available at http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf

the Proposed Rule to state clearly that such suitability criteria are to be evaluated as part of the customer's entire investment portfolio – not on a transaction-by-transaction basis.

- **Definition of "Essential Facts" Should be Clarified** - The proposed Know Your Customer Rule defines a broker-dealer's obligation to know their customer by requiring them to use "due diligence" in order to know the essential facts concerning every customer.[8] Among other things, Supplementary Material .01 defines these "essential facts" as those "required to…comply with applicable laws, regulations, and rules."[9]

  We believe that such a requirement is unnecessary in that the referenced laws, regulations, and rules already obligate broker-dealers to collect and maintain such information. If FINRA chooses to retain this requirement, we ask it that it provide more specific guidance to broker-dealers as to the obligations it imposes. Without this clarification, broker-dealer firms will lack the certainty necessary to achieve compliance.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to improve investor protection.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 379-0943.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO

[8] *See* Proposed FINRA Rule 2090.
[9] *See* Proposed FINRA Rule 2090.01.