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Quantitative Suitability: A Changing Standard?

By Anna T. Pinedo

At a time when the Securities and Exchange Commission has solicited comment on the proposed Regulation Best Interest, which would introduce a new and heightened standard of conduct for broker-dealers, FINRA chose to release Regulatory Notice 18-13. This Regulatory Notice solicits comments on proposed amendments to the quantitative suitability standard, which according to the notice, are intended to align with the standard articulated in the Commission's proposed rule. It is likely that the Commission's proposed Regulation Best Interest will be the subject of intense comment. The Commission's proposal follows on the heels of several years of debate and litigation relating to the Department of Labor's fiduciary rule, which was recently revoked. The timing of the proposed FINRA amendments is unusual when considered against this backdrop. It would be reasonable to have waited for the best interest standard to take shape and be formalized before proceeding with changes (to the extent any were warranted) to FINRA's suitability obligation.

Setting aside the odd timing, it is perhaps even more alarming that the Regulatory Notice suggests that it is appropriate to modify the quantitative suitability obligation in order both to make it easier for customers to bring actions and to prevail against broker-dealers in the name of investor protection. Taking a step back, let's consider the suitability obligation. FINRA Rule 2111 setting forth the suitability standard has been amended several times in recent years. In fact, in 2010, the Commission approved FINRA's proposed changes to the know-your-customer and suitability obligations. In 2011, FINRA provided guidance on the new rules, and the new rules were implemented in 2012. As amended, Rule 2111 requires that a member firm or associated person "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 reasonable diligence of the member or associated person to ascertain the customer's investment profile."

As revised in 2012, Rule 2111 articulated three principal suitability obligations: a reasonable-basis suitability obligation, a customer-specific suitability obligation, and a quantitative suitability obligation. The reasonable-basis suitability obligation requires that a broker-dealer have a reasonable basis to believe, based on its diligence, that a recommendation or a product is suitable for at least some investors. This means that a broker-dealer must understand the nature of a recommended strategy or strategies or a financial product, including understanding its risks and rewards. This element of the suitability obligation was consistent with prior articulations of the suitability obligation. Customer- specific suitability requires that a broker-dealer must have a reasonable basis, based on the customer's investor profile, to believe that a particular recommendation is suitable for that particular customer. This second prong of the standard also was familiar and well understood. In adopting the amendments, FINRA did expand the list of factors that a member firm must take into account when analyzing the appropriateness of recommendations, including a customer's age, investment experience, time horizon, liquidity needs, and risk tolerance, in addition to the customer's other investments, financial situation, financial needs, tax status, and investment objectives.

Taken together, these two elements of the suitability obligation had been articulated in many FINRA cases, as well as in court decisions. These elements essentially stood for the proposition that a FINRA member firm had to take into account the customer's best interests in connection with making a recommendation.

The last prong of the suitability obligation, or quantitative suitability, was added when FINRA amended Rule 2111. At the time, FINRA stated that the quantitative suitability obligation was simply a codification of excessive trading, or churning, cases. Quantitative suitability requires that a broker-dealer who has actual or de facto control over a customer account to have a reasonable basis for believing that, in light of the customer's investment profile, a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer. Indeed, this articulation of the obligation was consistent with the standard that had developed through

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court decisions. In churning cases it was necessary to show that the broker-dealer had actual control, such as discretionary trading authority, or de facto control over the client's account.

The proposed amendments would change the standard required to determine that a member firm has violated the quantitative suitability obligation. As proposed, the quantitative suitability obligation would apply even if the member firm does not have actual or de facto control over an account. Generally, cases have established that de facto control is proven where a customer has routinely followed the broker-dealer's advice, where the customer is unable to evaluate the broker-dealer's advice, and where a customer is unable to use the customer's independent judgment. Presumably, if the broker-dealer did not have actual control or de facto control, it could not be responsible for engaging in excessive trading or churning. It stands to reason that if a customer is directing the broker-dealer to make trades, the broker-dealer should not be held responsible for, and has not made, any recommendations. Similarly, if a customer is sophisticated and capable of evaluating a broker-dealer's recommendation, the customer can show that the trading was excessive in light of the customer's investment objectives, and that the broker-dealer made the recommendations with fraudulent intent (a showing of scienter). Usually in churning cases, the broker-dealer has engaged in excessive trading in order to generate commissions without regard to the client's interest. A broker-dealer, therefore, would have had to act with willful and reckless disregard for the client's interest or with an intent to defraud. Each of these elements of a churning case has been established through a long history of cases.

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FINRA has provided guidance regarding the types of factors that ought to be considered in assessing whether trading is excessive. FINRA has pointed to turnover rate, cost-to-equity ratio, and use of in-and-out trading in customer accounts. The turnover rate is determined by dividing the aggregate amount of purchases in an account by the average monthly investment. The cost-to-equity ratio is the percentage of return on the customer's average net equity needed to pay the broker-dealer commissions and other expenses.

In Regulatory Notice 18-13, FINRA solicits comments on amendments to the quantitative suitability obligation that would remove the element of control. FINRA notes that it proposes to remove the control requirement in order to align the standard with the Commission's proposed Regulation Best Interest. The notice states that "FINRA is concerned that the control element serves as an impediment to investor protection and an unwarranted defense to unscrupulous brokers." FINRA states that the control element is unnecessary but does not explain why the standard that has evolved through case law and that it found necessary in 2012 now is no longer appropriate. FINRA states in the notice that a customer would still have to make a showing that the broker-dealer of the member firm recommended the excessive trades. FINRA notes that the proposed amendments would not affect the "extensive case law concerning whether trading activity is excessive." However, that case law includes the requirement to prove the control element in a churning case. Why do the case law standards relating to excessive trading remain applicable, but not the control element? On excessive trading, the FINRA notice, citing various cases, states that a turnover rate of six or cost-to-equity ratio above 20 percent generally is indicative of excessive trading. Of course, what constitutes excessive trading is a fact-specific determination, but for this purpose FINRA does turn to case law for guideposts.

Why do the case law standards relating to excessive trading remain applicable, but not the control element?

Under Proposed Regulation Best Interest, broker-dealers cannot put their interests ahead of those of their retail customers. A broker-dealer will be found to have acted in the customer's best interest if it discharges three obligations: a disclosure obligation, a care obligation and a conflict of interest obligation. As part of the disclosure obligation, the broker-dealer must disclose in writing to its customer the material terms of the broker-dealer/customer relationship, set forth the relevant fees and charges, and describe the material conflicts of interest that relate to the recommendation. Under the conflict of interest obligation, the broker-dealer is required to establish, maintain

and enforce policies and procedures that are reasonably designed to identify and disclose or eliminate material conflicts of interest associated with the recommendation and the material conflicts of interest related to the broker-dealer's financial incentives.

The care obligation is quite similar to the FINRA suitability obligation. Under the care obligation, the broker-dealer must exercise reasonable diligence, care, skill and prudence to evaluate the recommendation and conclude the recommendation is in the customer's best interest. In describing the care obligation in the proposing release, the Commission notes that it differs from the suitability obligation because, among other things, it requires that a broker-dealer consider whether when viewed with other transactions effected by the customer, the recommended transaction is in the customer's best interest from a quantitative point of view. The proposing release distinguishes this requirement from churning, noting that to prove a churning claim under the Securities Exchange Act, courts and the Commissions have required that the broker-dealer exercise actual or de facto control over the customer's account. The Commission notes that eliminating the control factor in this prong of the requirements will ensure consistency with the other elements of the care obligation that apply, regardless of whether the broker-dealer exercises actual or de facto control over the retail customer's account. In addition to consistency, the proposing release notes that the enhanced quantitative standard would expand the number of customers that would benefit from the standard. A broker-dealer should not be absolved of its responsibility to have a reasonable basis for a recommendation even in instances in which a customer has knowledge of financial markets or exercises some control. The proposing release solicits comments regarding the elimination of the control prong. It may be the case that, based on the comments it receives, or other factors, the Commission may determine not to incorporate this change into the final Regulation Best Interest. Like the FINRA notice, the proposing release acknowledges the standard established through case law to prove churning claims. In so doing, it is unclear whether "churning" would continue to be subject to the standards established by judicial precedent, and a violation of the quantitative suitability would come to be viewed as something different from "churning." In any event, before setting aside a well-understood standard, it would be both prudent and logical for FINRA to consider not only the comments to its regulatory notice but also the final Regulation Best Interest.

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