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Suitability Rule Consolidation

The FIRE Solutions Firm Element CE Course *Suitability and Supervision* contains a mix of current rules and approved updates to the FINRA suitability rules illustrating what is currently required, and what *will be* required. On July 9, 2012, NASD Rule 2310 will be replaced with FINRA Rule 2111 (Suitability). The following is a brief outline of the changes to come in the new FINRA Rule 2111. The full details, examples, illustrations, and case studies are included in FIRE's *Suitability and Supervision* CE course, as well as several other courses that review suitability rules.

Perhaps the most significant changes to the suitability rules involve the addition of:

- "Quantitative analysis" to the general suitability standards
- "Strategy recommendation" that will trigger the suitability rule requirements

❖ Quantitative Suitability Analysis

When FINRA Rule 2111 goes into effect, a firm or representative who has discretionary authority or "de facto control" over a customer account must have a reasonable basis for believing that the level of activity in the account is suitable for that client. "De facto control" is when clients routinely follow their representatives' advice because they are unable to evaluate the risks involved in the recommendations or exercise independent judgment.

Therefore, even if the transactions in the account are suitable, they must be analyzed collectively to ensure that the activity is not excessive. When assessing the level of activity, one of the following factors may be used:

- **Turnover rate** measures on average, how many times the holdings in an account are traded over a one-year period (includes only those transactions recommended by the representative). An acceptable turnover rate depends on the suitability factors of the client.
- **Cost-to-equity ratio** measures the annual cost of trading represented as a percentage of the customer's holdings (only for those transactions recommended by the representative). Much like the 5% markup/down rule, a maximum of 5% of the cost-to-equity ratio is a good rule of thumb.
- **Use of in-and-out trading** is a trading strategy with a high turnover ratio. This is in contrast to a "buy and hold" strategy, when "buy and hold" would be more appropriate for that client.

❖ Strategy Recommendations

Under the FINRA Rule 2111 updates, the recommendation of an investment "strategy" will require representatives to determine if the strategy is suitable for that particular client. The term "strategy" has a very broad interpretation. The spectrum could be as complex as a fully diversified portfolio, to as simple as telling a customer to "hold" a particular investment. The point is, a



strategy recommendation need *not* result in a transaction or a commission. As with investment recommendations, a strategy recommendation will trigger the new rules' suitability requirement.

❖ **Additional highlights included in our *Suitability and Supervision* course:**

Recommendations

Students will examine what constitutes a recommendation under current rules and when the suitability requirements are triggered.

Reasonable Basis Analysis

All of our courses that outline basic and complex suitability requirements discuss the importance of a reasonable basis analysis, as well as the specific components of the due diligence process.

Customer-Specific Analysis

A customer-specific suitability analysis lists the five new data elements required in the customer profile information. In addition, the course examines four suitability elements of each client in order to match them with the appropriate product.

Institutional Investor Suitability

Included in the *Suitability and Supervision* course is a detailed description of which aspects of Rule 2111 will change the way institutional representatives make recommendations.

Was this excerpt everything that you thought it would be? Are there *suitability or compliance-related issues* that FIRE could report or investigate for you? FIRE wants to hear all feedback regarding this excerpt. Click [here](#) to let us know your thoughts.
