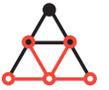


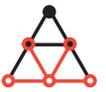
Suitability Obligations When Using Specialists



About the Authors

John Duval, Sr. has a 30-year background in the financial services industry, including six years of management at the branch and district level. As part of his managerial experience, John managed the Merrill Lynch New York City District Professional Resource Center, which included over 40 product and service specialists serving over 700 representatives and their clients. In addition, he is a FINRA arbitrator as well as an industry expert witness in securities disputes.

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Introduction

The specialist system has existed in the brokerage world since the 1980's, however, it has not received a great deal of regulatory or expert commentary. This is remarkable since the use of specialists is common throughout the industry, particularly in the sales of complex products.

This paper explores the suitability obligations of Registered Representatives and product specialists when jointly making recommendations to clients. The origin and evolution of the specialist system is examined along with the functions typical of specialists. The industry distinction between “inside” and “outside” specialists is described, and selling agreements between Broker-Dealers (“BDs”) and outside specialists are examined as well.

Most importantly, a critical potential dilemma is explored in regards to suitability: what happens if the Registered Representative knows the client, the product specialist knows the product, but neither knows both?

The answer, in short, is that the Registered Representative has ultimate responsibility for the suitability of all recommendations to the client. However, if the Registered Representative involves a specialist in the recommendation at any time, then *both* must know the client and the investment well enough to make a suitability determination. If either fails in this regard, then the recommendation cannot be said to be suitable.

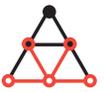
Background

In the beginning of the 1980's, many large BDs began to build what would later be called “financial supermarkets”, where their clients could get all their financial needs met at one location. This development resulted in the expansion of the range of offerings available: from traditional investments such as stocks, bonds, and mutual funds; to life insurance and annuities, retirement plans, business loans, and mortgages, just to name a few.

The enhanced complexity of these new platforms meant additional training was required for Registered Representatives (hereafter “representatives”) and other associated persons of the BDs. However, even with training, the range of offerings was so broad (and some of them so technical) that it was not efficient or reasonable to expect any one representative to acquire and maintain a complete knowledgebase on every product and service their firm offered.

To address this reality, many BDs created a “specialist system”, whereby a given product expert would support many offices of representatives. If a representative thought a particular product might be appropriate for a client, she could call in the product specialist to assist in the client evaluation and sale.

The specialist system still exists today, even though some firms have moved away from the financial supermarket model. Most notably, the specialist system has expanded because of the increasing complexity of investments such as structured products, variable annuities and variable life insurance.



What is a “Specialist”?

Specialists serve a number of distinct functions within the brokerage world. Some of these include:

- > Maintaining product or service expertise;
- > Providing sales assistance to representatives, including meeting with clients;
- > Educating representatives about products and related industry rules and regulations.

While carrying out these functions, specialists are frequently called in by representatives to assist in large and complex transactions or to help explain complex products to clients. They are often brought in early in the sales process to help determine suitability, go over product specifications, and meet with clients.

Many specialists are involved with products that are issued with 100+ page prospectuses or offering memorandums. These documents are frequently replete with industry terms of art and require the simultaneous understanding of many different investment-related concepts. The specialist must not only have mastered the material but be able to explain the contents to both the representatives and their clients in plain English.

Inside and Outside Specialists

Specialists can be divided into two primary types: “inside” and “outside”. In short, inside specialists are employed by the same firm that employs the representative, and outside specialists are employed by third party firms or product issuers such as mutual funds and life insurance companies.

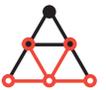
Many of the qualifications and functions of inside and outside specialists are identical, irrespective of their employer. For instance, if a specialist is involved in selling a registered product, then the specialist herself needs to be registered with FINRA, to the same extent required of the representative. Typically, a specialist will hold the Series 7 (General Securities Representative) or Series 6 (Investment Company Products/Variable Contracts Limited Representative) license, and should be familiar with the rules and regulations of the industry, including suitability.

Inside Specialists

An inside specialist (also sometimes known as an “in-house” specialist) is employed by the same BD as the representative and receives compensation consisting of a salary and bonuses based on the volume of products sold within her respective business unit and territory. In addition to assisting in sales, they are frequently involved with training representatives about new product offerings. They also serve as an in-house resource for representatives who have questions about their product specialty.

Outside Specialists

Outside specialists (which are also known as wholesalers) are typically employees of product issuers like mutual funds or life insurance companies. Similar to inside specialists, outside specialists also typically have geographic responsibilities and are compensated by a salary and bonuses based on the volume of products sold in their territory. A key difference is that an outside specialist will frequently be serving multiple BDs.



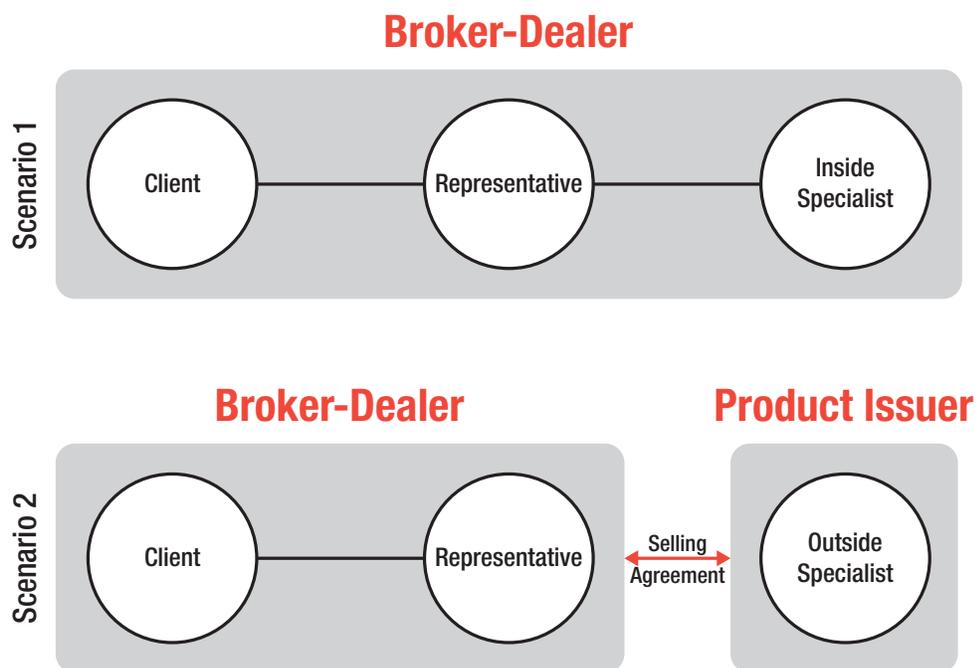
Selling Agreements

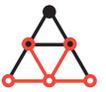
Since outside specialists are not on the BD payroll, there necessarily exists a selling agreement between their third party employer/issuer and the BD. A closer look at the usual language found in a selling agreement is an important step to understanding the relationship between the outside specialist, their firm, and the BD. A typical selling agreement will include the following elements:

- > Compensation arrangements, including specific disclosure of gross commissions generated (by product or service) and percentage splits;
- > The basis for commission reversals;
- > Venue for dispute resolution in the event of a material disagreement;
- > Term and length of contract;
- > Conditions pertaining to appointment of representatives to sell their products.

Chart 1, below, illustrates the interaction of both inside and outside specialists with the BD, representative, and client.

CHART 1.





Suitability Obligations of Specialists

Suitability can be described simply as matching an investment or strategy to the individual investors' particular facts and circumstances. In order to accomplish this, the representative must know both the client and the investment.

The suitability obligation is clearly spelled out in FINRA Suitability Rule 2111, which contains both customer-specific and reasonable-basis components.³ FINRA Rule 2111 states, in part:

- (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. 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.⁴

The customer-specific suitability part of the rule is satisfied by the representative, and involves the suitability of recommendations as they relate to a specific customer's unique facts and circumstances. The reasonable-basis suitability part of the rule is fulfilled first by the member firm and then by the representative. Initially, this determination involves a due diligence investigation by the member firm into the investment to determine if it should be offered to any of their clients.⁵

The specialist can play an important role in the reasonable-basis due diligence process. They should have deep industry knowledge within their specialty and could help their firm vet a new product. More frequently, the specialist helps the representative with her due diligence process by determining if a product is suitable for a particular client.

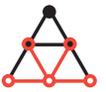
Specialist-Client Interactions

A potential problem arises when the representative, who knows the client, and the specialist, who knows the product or strategy, come together to make a recommendation to the client. The representative and specialist can both be assumed to know (respectively) the client and the product, but what if neither knows both? In such an instance, can a suitable recommendation be made?

3 These obligations existed under FINRA Rule 2310 (Recommendations to Customers) and various Regulatory Notices before FINRA Rule 2111. For more detailed analysis see Accelerant Whitepaper: *Leveraged and Inverse ETFs: Trojan Horses for Long-Term Investors*.

4 FINRA Rule 2111. This rule replaced Rule 2310 (Customer Recommendations) and is effective from July 9, 2012.

5 *Id.* at Supplementary Material .05 Components of Suitability Obligations.



Very simply, the answer is no. We examine this question from the perspectives of both the representative and specialist, below.

Representative Suitability Obligations When Working with a Specialist

In short, the overall suitability obligation rests squarely on the shoulders of the representative. There is no way for a representative to disclaim any of the suitability obligations under Rule 2111,⁶ even if a specialist is involved in the sale.

The first priority of a representative is to know their client, which is done through what is known as profiling. Indeed, the new FINRA Suitability Rule 2111 incorporates the phrase “customer’s investment profile” and imposes an affirmative duty upon the representative to gather certain critical information, including: the customer’s needs; the customer’s investment time horizon; the customer’s liquidity needs; and the customer’s risk tolerance.⁷

If the profiling process is not thorough, then the representative cannot be said to know the client and a suitable recommendation cannot be made. However, merely knowing the client is not sufficient, the representative must also know the investment.

How well must a representative know the investments she recommends? Well enough to make a suitability determination about that investment for her particular client. At the very least, her knowledgebase would include the following:

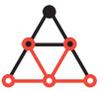
- > Essential features;
- > Investment risks;
- > Liquidity considerations;
- > Appropriate time horizon;
- > Basic tax implications;
- > Commissions and cost structure;
- > Any surrender penalties or other exit fees.

These basic details would need to be disclosed to the client as part of the recommendation process.

However, even if the representative possesses knowledge of the basics listed above, a specialist may still need to be brought in to explain certain features, considerations, or other complexities.

6 *Id.* at Supplementary Material .02, Disclaimers.

7 *Id.* An affirmative duty to profile the client has existed for representatives since January 1991 after Article III, Section 21 (c) of the Rules (the predecessor to FINRA Rule 2310) was amended under FINRA NTM 90-52.



Specialist Suitability Obligations When Working with a Representative

If the specialist is an associated person⁸ with a FINRA member firm, and knows the client, then they have a clear suitability obligation under FINRA Rule 2111 for any recommendations. They can learn about the client from a new account form, a financial plan, or other document containing client profile information, or from conversations with the investor and representative.

As discussed above, the basic customer-specific facts the specialist would need to know, include:

- > Age;
- > Other investments;
- > Financial situation and needs;
- > Tax status;
- > Investment objectives;
- > Investment experience;
- > Time horizon;
- > Liquidity and cash flow needs;
- > Risk tolerance;

A key question for the applicability of the suitability rule to a specialist revolves around FINRA's standard of what constitutes a "recommendation". FINRA has addressed this in the context of online trading firms issuing generic buy recommendations on stocks. A two-fold standard was established to determine if a recommendation had been made (and thus would be subject to the suitability rule):

1. The communication must be a "call to action" to the client; and
2. The more tailored the communication was to a client's specific facts and circumstances, the more likely it was to be a recommendation.⁹

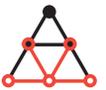
Very simply, if a communication is made to the client calling them to action, and the communication was made specific to the client's particular facts and circumstances, then it is a recommendation.

However, this standard creates two scenarios in which a specialist would *not* be subject to the suitability obligation:

- > The first is a situation where the specialist is not making a call to action to a client, but is communicating generically about a particular product or service to the representative. Such scenarios could include: educational and training presentations; product "roll out" meetings; and general inquiries from representatives with non-client specific questions.
- > The second is the rare case where a specialist meets with a representative and client to discuss a product, is fully informed of the client's specific facts and circumstances, but no call to action is ever made to the client to purchase the product.

⁸ FINRA defines an associated person, in part, as "a natural person registered under NASD (now FINRA) rules..." See FINRA Rule 1011 (Definitions).

⁹ See FINRA NTM 01-23 (Online Suitability).



Importantly, the suitability obligation would be in effect if the specialist met with the representative and client and the sale was consummated at a later date after other discussions or meetings with the representative. In this scenario, the specialist's participation would have been part of the recommendation and in contemplation of the call to action to the client.

Conclusion

If a specialist is at any point involved in a recommendation to a client, then the specialist must know enough about the client to make a suitability determination. Commensurately, the representative must also know enough about the product to make a suitability determination. If either fails in this regard, the recommendation made cannot be said to be suitable.

Irrespective of specialist involvement, under FINRA Rule 2111 (and its predecessor, Rule 2310) the ultimate responsibility for a suitable recommendation lies with the representative. The representative knows the client better than anyone at her firm and is the one inviting the specialist in to help with the sale. However, if the specialist is at any point involved in the recommendation to the client then the specialist is subject to the suitability rules as well.



About Accelerant

Accelerant (www.accelerant.biz) is a securities litigation consulting firm specializing in large and complex cases. We bring broad and deep securities and regulatory knowledge as well as analytic rigor to our work. Our experts have industry, academic, and regulatory experience which they bring to bear on all client matters.

Accelerant's clients value our ability to communicate complex ideas simply, our reputation for unbiased, independent and high quality analysis, and our commitment to a highly responsive work ethic.

Headquartered in New York City, Accelerant also serves clients from our Hong Kong and London offices.

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