Who's risking your business? (Part II)

Michelle L. Jacko, is the CEO of Core Compliance & Legal Services. She also is managing partner and CEO of Jacko Law Group. She can be reached at www.corecls.com.

As the financial crisis unfolds, the SEC and FINRA continue to crack down on perceived weaknesses in internal control systems. One critical focus of regulatory investigations is the suitability of any recommended transactions. Suitability determinations are an essential aspect of overall sales practices relating to investment products and services. Not only does FINRA require "reasonable grounds for believing that the recommendation is suitable for (each) customer," (NASD Rule 2310) but the SEC and state regulators have treated suitability as a fundamental duty of advisors and will enforce it under anti-fraud provisions. There are three focus areas to ensure regulators leave you alone:

Conducting a suitability analysis. Understanding the customer's overall needs and particular investment horizon is critical to the suitability determination. Information regarding the client's intended purpose for investing, liquidity and possible income needs are all important considerations that must be documented as part of the analysis of investment objectives.

In addition to a clear understanding of the customer's intentions and objectives, investment recommendations must be consistent with the customer's risk tolerance. Thus, even if a customer's objectives are to engage in a speculative investment, such securities should not be recommended if they are inconsistent with the product's minimal qualification standards or the customer's financial situation. Therefore, representatives must be adequately trained to properly assess the recommended product in light of all aspects that bear on its potential risk of loss for the customer.

Applying specified suitability standards. While general suitability principles remain the same, there are a number of specified suitability considerations applicable to certain types of investors and securities. Institutions are traditionally more sophisticated and not seen as needing the same disclosures as retail investors with regard to the merits and risks inherent within a transaction. Additionally, the analysis of an institution's financial situation often comes in the form of an SAS 70 report and not from detailed interviews. Nevertheless, firms must engage in appropriate suitability determinations for institutional customers, which includes the institution's ability to evaluate investment risk and the extent to which the institution is exercising independent judgment. Importantly, however, the suitability of variable annuities and variable life insurance must be based on the traditional standard with the added element of disclosing of the associated transactional and investment costs and considering whether an alternative investment product may offer lower costs and better performance.

Training and compensation practices. Financial institutions involved in recommending securities transactions must consider the degree to which employees are trained on applying suitability determinations as a routine aspect of their sales practices. The general principle of suitability obligations should be a common theme when designing internal sales training sessions. Improper training techniques can be a basis for liability at the firm level for unsuitable recommendations made by representatives.

During this market environment, it is essential for all firms to remember their compliance obligations. Check your policies and procedures to ensure they satisfy current customer protection standards when determining overall suitability with regard to each transaction.