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**Risk Management Update**
**June 2012**

## LATEST UPDATES ON FINRA FOCUS REPORTS AND SUITABILITY RULES: WHAT YOU NEED TO KNOW

This month's Risk Management Update focuses on two new FINRA rules that may impact broker-dealer compliance programs which may necessitate updates to your Written Supervisory Procedures, internal operations and more.

### New and Improved FOCUS Report is Coming!

The SEC has approved new FINRA Rule 4524, which requires the filing of additional FOCUS information along with a supplemental schedule to the statement of income. This information will provide more detail about the firm's source of revenue and expenses to enable additional oversight from FINRA that may help to provide an extra layer of protection for investors.

The implementation date for this rule change was February 28, 2012 and the due date of the new schedule, covering the quarter ending September 30, 2012, is October 26, 2012.

In order to complete the Supplemental Statement of Income (SSOI) for FINRA you may need to enhance your current internal reports in order to be able to capture this data. There is a de minimus exception for revenue and expenses. If the aggregate amount is less than the greater of $5000 or 5% of the firm's total revenue or total expense, you would only be required to enter the aggregate amount on the form.

Each firm is required to file the SSOI within 20 business days of the end of each calendar quarter. For more information and further guidance please refer to the general instructions on FINRA's website, which can be found at: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p125702.pdf.

### FINRA's New Suitability Rule

Suitability has long been a focus of FINRA and serves as the foundation for protecting investors. In an effort to help ensure that member firms are capturing necessary customer information in order to confirm that investment recommendations are suitable, FINRA has issued additional documentation requirements through Rule 2111.

Rule 2111 takes effect on July 9, 2012. Importantly it enhances the old NASD Rule 2310 by clarifying the type of information broker-dealers should be obtaining for all customers in order to provide suitable recommendations based on their needs.

This includes, among other things: the customer's age, other investment holdings, financial situation and needs, current tax status, investment objective, risk tolerance, investment experience, time horizon, liquidity needs, and any other information deemed necessary by the broker-dealer in order for registered personnel to make an informed recommendation.

The new rule also applies to recommended investment strategies involving a security or securities which should be interpreted broadly. It lists three main suitability considerations for recommending investment strategies including: reasonable-basis, customer-specific suitability and quantitative suitability. Reasonable-basis requires a broker to have a reasonable basis that the recommendation is suitable. Customer-specific suitability requires that the broker believe the investment is suitable based on the customer profile. Quantitative suitability requires the broker to have a reasonable basis for making a series of recommendations that are not excessive when viewed as a whole or unsuitable for the customer. Moreover, the broker must ultimately have a solid understanding of the product(s) they are recommending and the needs of the customer.

Notably, there is an institutional investor exemption. In order to apply, the broker-dealer must:

- define the customer as an institutional account pursuant to NASD Rule 3110(c)(4;
- believe the customer is capable of evaluating the investment risks; and
- have the institutional investor acknowledge that they are exercising their own judgment when making investment decisions.

You should also be aware of your communications with a customer being viewed as a recommendation; the more detailed and customized it is for that particular customer the better the chance that it will be deemed a recommendation. Please review the Additional Guidance on FINRA's New Suitability Rule, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf. This regulatory notice provides industry questions and answers on the following topics:

- the obligation to act in a customer's best interests;
- the scope of the terms "recommendation", "customer" and "investment strategy";
- the use of risk-based approach to documenting suitability; and
- the institutional customer exemption

To assist, FINRA is providing a very useful new account template on their website which can be further customized to fit your needs. Please review http://www.finra.org/Industry/Tools/P117268 for more information.

What you should do now:

1. Be sure to review FINRA's new Focus Report instructions to capture additional data points necessary for completing the SSOI.
2. Amend internal reports, as necessary, to capture expense and revenue details.
3. Amend the firm's Written Supervisory Procedures to reflect new Focus filing requirements as well as new suitability requirements.
4. Enhance existing new account forms to include additional suitability fields.
5. Provide training for registered representative and operations staff on the new suitability information you will be capturing and how this will be incorporated into your existing account opening and investment procedures.

As always a proactive approach to new rule requirements is always the best course of action. For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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