

A Guide to Answer That Age-Old Question: So What Does it Mean to Know Your Customer?



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- Introduction
- What Personal Information Should be Gathered by the Broker-Dealer/ Investment Adviser
- What Additional Information Should the Broker-Dealer/ Investment Adviser Collect
- Conclusion

Introduction

So now that you have secured a client relationship, the age-old question that every financial adviser faces is: “Do I adequately know my customer?”

The answer to this question necessarily serves as the underlying basis regarding the suitability of any investment recommendation and should be obtained on the front-end of the client/adviser relationship, as opposed to being debated during the trial involving a customer-initiated complaint. Notwithstanding the importance of knowing your customer, all too often this information gathering process is not given its proper weight.



The following provides guidance pertaining to the information that should be gathered from every new client and maintained over the life of the client/adviser relationship. In addition, this guide contains suggestions on how you can improve your client account forms to ensure adequate “know your customer” information is gathered and maintained. Conducting adequate fact gathering will protect you from potential liability, ensure that you make suitable investment recommendations and preserve good client relations.

What Personal Information Should be Gathered by the Broker-Dealer/Investment Adviser

The best way to approach the “know your customer” fact gathering process is to develop a standard set of inquiries. By maintaining a standard set of inquiries, fact gathering can become second nature and more easily defended if questioned by a client. With Rules 2090 and 2111, FINRA has attempted to define what it means to know your customer, as well as the information that must be gathered to ensure suitable investment recommendations. Following the guidance of these rules will assist you in the development of your standard set of inquiries. These rules are effective as of July 9, 2012, and should likewise guide registered investment advisers regarding their know your customer and suitability analysis.

Rule 2090 requires the use of reasonable diligence when opening and throughout the maintenance of client accounts. You must know and retain “essential facts” concerning every customer, including the authority to act for the customer. FINRA has defined essential facts as those required to: (a) effectively service the customer’s account; (b) act in accordance with any special handling instructions for the account; (c) understand the authority of each person acting on behalf of the customer; and (d) comply with applicable laws, regulations and rules.

Under Rule 2111, FINRA has now defined “suitability.” According to Rule 2111, there must be a reasonable basis to believe that the recommended transaction or investment strategy involving a security is suitable for a customer. Importantly, an investment strategy includes recommendations to buy, sell or hold a security, an area that was open to some debate in the past. Suitability is also “based on the information obtained through the reasonable diligence of the member or registered representative to ascertain the customer’s investment profile.” Rule 2111 goes so far



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as to describe the categories of information that must be obtained to ascertain the investment profile and evaluate the suitability of an investment recommendation. The following (not necessarily in order of priority) overlapping areas of inquiry should be your focus: personal information, current financial position, investment goals and objectives and tolerance for risk. Only after you gather this information can you truly know your customer and be able to make suitable investment recommendations.

A. Personal Information

On the personal level, every financial adviser should gather the following information from a prospective client:

1. Age.
2. Marital status.
3. Education (including the highest level attended).
4. The identity of all dependents and children, including ages, educational needs/goals and whether any dependents/children have special needs.
5. Employment status (including planned age for retirement).
6. Citizenship and residence. This inquiry should include whether the person rents or owns the primary residence, as well as any vacation homes.
7. Basic understanding of the customer's health.
8. Any special situations that may require the outlay of significant resources; e.g., purchase of a home (primary or vacation) or automobile, planned early retirement, retirement facility, healthcare, etc.
9. Prior investing experience, which would also require an understanding of whether the person previously worked with a financial adviser or handled investment decisions exclusively on her own. If the person previously worked with a financial adviser, you should explore why the client is seeking to make a change.
10. Short-term and long-term goal for investment dollars.
11. Liquidity needs.
12. Willingness to lose money over the short-term in exchange for long-term gain.
13. Hobbies/activities that require the expenditure of capital; e.g., travel, sporting/cultural events, etc.
14. Estate planning needs including, among other things, tax planning.



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B. Financial Information

Although it is self-evident that a financial adviser needs to obtain financial information from a prospective client, all too often there is not enough information gathered. The important areas of focus regarding a person's financial situation include at least the following:

1. All sources of current income; i.e., employment, IRAs, pension, trusts, rental properties and investments. The best source of information is to ask for state and federal tax returns for the prior two years, including W-2s, K-1s and/or 1099s.
2. All sources of future income (including current value); i.e., pensions, IRAs, 401Ks, 403Bs, ESOPs, DRIPs, trusts, employee retirement accounts, etc.
3. Investment account statements for at least one year for both qualified and non-qualified accounts.
4. Current asset breakdown by investment class.
5. A breakdown of monthly hard costs; i.e., mortgage, rent, car, food, energy, health care, education and clothing.
6. A breakdown of non-essential monthly costs; i.e., entertainment, travel and hobbies.



What Additional Information Should the Broker-Dealer/Investment Adviser Collect

The information that the financial adviser collects about a prospective client (and maintains over the life of the relationship) will form the framework for the responses to questions typically posed on account opening questionnaires. Account opening questionnaires have historically contained standard boxes for risk tolerance and investment objectives. Risk tolerance forms typically contain the following categories: conservative, moderate conservative, moderate, moderate aggressive and aggressive. Although these types of forms have an important place in the know your customer analysis, when faced with a complaint, these forms unfortunately often lead to a subjective debate regarding what the customer meant when she checked moderate-conservative. For example, moderate-conservative in the 1990s versus the 2000s may be completely different depending who you ask and when you ask the question. Best practices suggest that the broker-dealer/investment adviser should couple these forms with more objective questionnaires that require more meaningful thought on the part of the customer, as well as the financial adviser.



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An effective questionnaire asks a series of questions that go to the heart of investment objectives and tolerance for risk. With respect to investment objectives, the following questions are worthy of consideration:

1. In any given 12 month period, I/we would like to earn ___% on my investment dollars.
2. Over my/our investment time horizon of ___ years, I/we would like to earn an average annual return of ___%.

As to a customer's tolerance for risk, you may want to consider including the following types of questions:

1. In any given 12 month period, I/we am/are not willing to lose any of my/our investment principal. Yes___; No___.
2. In any given 12 month period, I/we am/are willing to lose ___% of my/our investment principal.
3. In any given four consecutive quarters, I/we am/are not willing to lose any of my/our investment principal. Yes___; No___.
4. In any given four consecutive quarters, I/we am/are willing to lose ___% of my/our investment principal.
5. In any given 12 month period, I/we am/are willing to lose ___% of investment principal in exchange for long-term gains over my investment time horizon of _____ years.
6. In any given four consecutive quarters, I/we am/are willing to lose ___% of investment principal in exchange for long-term gains over my investment time horizon of _____ years.

Although there are many permutations to the answers of these questions, the fundamental goal is to force the customer to provide their own assessment of their objectives and tolerance of risk. These questionnaires should also contain a signature line below a certification, stating that the customer reviewed the form with the financial adviser and that the customer answered the questions in his/her own handwriting. By doing so, the claims of a disgruntled client that the adviser completed the form or had the client sign the form in blank can be limited. As the relationship with the customer progresses, best practices dictate that these questionnaires be completed by the customer on a regular basis to assess whether any changes are required to their investment objectives and tolerance for risk.



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Equally important — and separate from the SEC Books and Records requirement to review clients' accounts every three years — on at least a yearly basis, an investor verification form should be sent to each client that identifies the customer's investment objectives and tolerance for risk as that information appears in the customer database maintained at the broker-dealer/investment adviser. The investor verification form must also require that any changes be made by the customer on the form and that the client return to the company the revised form within a specific period of time. Like the investor questionnaire, the investor verification form should contain a certification adjacent to the customer signature line where the customer represents that any changes to the form were made by the customer in his/her handwriting.

Conclusion

The key to any successful client/adviser relationship is for the financial adviser to know her customer and then make suitable investment recommendations. If a financial adviser does not approach the know your customer process with an adequate and consistent plan in light of the current regulatory scheme, then the adviser may not be in a position to make suitable investment recommendations and, in turn, be subject to the risk of claims asserted by a dissatisfied client. The foregoing should provide financial advisers with a framework to conduct the know your customer analysis and to better preserve client relations.

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