

CHAPTER SIX

Suitability, Risk, Economics, and Business Conduct

One of the most important functions of your job may be to make appropriate recommendations for your clients. Successfully accomplishing this requires a full understanding your clients' goals as well as the products that you are selling, so that you can determine if what recommendations are suitable. Making suitable recommendations also includes understanding the risks and economic factors that influence the performance of investments, such as business cycles, monetary and fiscal policy, and foreign trade. Finally, it requires knowledge of appropriate business conduct. This chapter will focus on suitability, risk, economic factors, and business conduct.

SUITABILITY

While some ethical standards for securities professionals are simple black and white, do this or don't do that, kind of rules, others are a lot more gray. Suitability is one of those concepts that require professionals to make an ongoing effort to ensure that they are looking out for their clients' best interests and walking the ethical line. In fact, selling products that are suitable for a client is a big part of a principle that FINRA values highly: dealing fairly with the public.

Suitability is the concept that not all investments are right for all clients, due to a wide variety of factors. One set of factors includes an investment's cost, level of risk, expected return, and growth or income features. Another set includes the investor's risk tolerance, liquidity needs, investment experience, current portfolio composition, investment objectives, time horizon, tax situation, and amount of funds to invest.

In other words, a top-ranked mutual fund that has posted great growth for ten straight years in a row may be inappropriate for someone who never, ever wants to see his investments have a negative performance year. Likewise, someone who hopes to grow her investments at a rate that exceeds inflation should not have the bulk of her money parked in low-yield savings accounts for any extended period of time. Suitability involves making

sure clients are taking enough risk to meet their goals, just as it can be about making sure clients are not taking too much risk to keep them from reaching them.

Over time, a registered representative continually reassesses suitability by evaluating whether investments that were once suitable for a client are no longer a good match. For example, clients who invested in a growth fund throughout their working years to maximize returns may find the risk of such a fund to be unsuitable once they begin living off their nest egg and want to protect their principal. As an investment begins to appear unsuitable for a client, representatives have a discussion about the situation with their client, outlining their concerns and making more appropriate recommendations.

BLANKET RECOMMENDATIONS

A blanket recommendation is when a firm or financial professional makes a recommendation to all their customers to buy or sell a particular security. Since a blanket recommendation does not consider whether the action is suitable for each individual customer, making such a recommendation is generally prohibited.

BROKER-DEALER SUITABILITY RULES

Broker-dealers must believe on reasonable grounds that the transactions or strategies they recommend are suitable for an individual customer. Firms may approve an account only after conducting a suitability analysis, based on the firm's due diligence in understanding the risks of the recommendations they make and the customer's personal and investment profile. They must make "reasonable efforts" when opening an account to collect and maintain this information.

Specifically, FINRA recognizes three components with regard to suitability obligations:

- **Reasonable-basis obligation.** A broker-dealer and registered rep must understand the complexity and risks of a security or investment strategy and consciously determine whether it is suitable for at least some investors. If a firm or its brokers and dealers do not understand the risks and mechanics of mortgage-backed securities, for example, it is a suitability violation to recommend them to investors.
- **Customer-specific obligation.** A broker-dealer and its representatives must have a reasonable basis to believe that a recommendation is suitable for a specific customer, based on the customer's personal and investment profile. The suitability analysis must evaluate the customer's investment objectives and time horizon and her financial status, including current income, tax status, other investments, and liquid net worth. Personal characteristics must be examined also, such as age, employment, dependents, trading experience, and risk tolerance.
- **Quantitative suitability obligation.** A broker-dealer who has control over a

customer account must have a reasonable basis to believe that a series of recommended securities transactions are not excessive.

A representative should use reasonable diligence to obtain the suitability information listed above before working up an investment strategy and making recommendations for a customer. While some of the information may be more important than others, depending on the client's situation, the representative should document any information that was not collected, and try to obtain this information in the future. Under the rule, a recommendation to hold onto a security is still considered a recommendation.

A broker may accept unsolicited orders from a client who has not provided the appropriate suitability information.

SUITABILITY QUESTIONS ON THE EXAM

For the Series 6 exam, suitability will probably be tested through scenarios that describe different clients, and you will be asked to pick the most or least suitable investment for the client. Thus, it is wise to think about suitability as you review the different investment vehicles discussed in Chapters Two through Five. Here are some general principles to follow:

- A young person who is just beginning to invest and has a long time horizon will be best served by growth stocks or growth funds.
- A client in a high tax bracket should consider municipal bonds or municipal bond funds.
- An older person who needs income should not invest in an annuity, because they usually have long surrender periods.
- An investor who needs income could invest in bonds, bond funds, or preferred stock.
- Most people should contribute the maximum amount to their IRAs before investing in an annuity.
- An investor should not put an annuity into an IRA, because they are both tax-advantaged investment vehicles.
- An investor who may need his funds on short notice should not invest in illiquid assets like annuities, B shares, private placements or hedge funds.
- Equity securities are usually best for someone with a long time horizon who is seeking higher returns, but has no immediate need for income, whereas debt securities are better suited for those seeking an income stream.