



# COMPLIANCE BULLETIN



## Customer Identification & Verification

2017

# Customer Identification & Verification

Proper identification of customers has two major benefits: appropriate customer suitability analysis, and the identification of suspicious activity such as the funding of terrorism, money laundering, or other actions that undermine the integrity of the financial system. Under each firm's mandated Customer Identification Program (CIP), financial institutions are required by federal law to obtain, verify and record information that identifies each person who opens an account. While CIP is a one-time requirement, Knowing Your Customer (KYC) is broader in scope, covering both account opening and maintenance on an ongoing basis.

## **Customer Identification Program: the Patriot Act**

The terrorist attacks of September 11<sup>th</sup> created an overwhelming desire to “do something” in order to prevent another attack. In an effort to bolster the power of the intelligence community in its effort to root out terrorism, Congress passed the Uniting and Strengthening America by providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, better known by its acronym the USA PATRIOT Act. The Act was put in place to regulate financial transactions, with broker dealers as the primary means of enforcement through a newly created Customer Identification Program.

As a result, Code of Federal Regulations Rule 31 CFR 103.122 requires broker dealers to create Customer Identification Programs (CIP) appropriate for their size and business activity. While necessarily voluminous, the overall intent of the rule can be summed up in few words: each customer who opens an account should provide an ID.

- A customer is a person that opens a new account, or an individual who opens a new account for an individual who lacks legal capacity or is not a legal person. The definition of customer does not include a financial institution regulated by a Federal functional regulator or a state, which means that broker dealers do not have to treat each other as customers nor their customers as customers.
- An account means a formal relationship with a broker-dealer established to effect transactions in securities, including, but not limited to, the purchase or sale of securities.



- Identification of individual investors refers to name, date of birth, address and identification number such as a Social Security number. For a non-U.S. persons, other documents can be used, including passport number and country of issuance, alien identification card number, or number and country of issuance of any other government issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

For institutional investors, the above requirements do not apply, but the firm must still obtain proof that the institutional investor is who it says it is. This can be obtained through articles of incorporation or other documents showing that the firm is in good standing.

### **Know Your Customer: FINRA**

FINRA, meanwhile, has continuously refined its rules regarding customer suitability for over 70 years. Again, these are more applicable to individual investors than institutional investors. However, some degree of analysis for institutional investors is necessary as well, as described below.

FINRA Rule 2090 (Know Your Customer) requires firms to use “reasonable diligence” in regard to the opening and maintenance of every account, to know the “essential facts” concerning every customer. The rule explains that “essential facts” are “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.” The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation.

FINRA Rule 2111 requires that a firm or associated person “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.” The rule further explains that 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.” This requirement applies to institutional investors as well as individual investors.

The suitability analysis has three principal components:

1. The “reasonable basis” suitability analysis requires the brokerage firm to have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. In other words, the broker-dealer is responsible for conducting its own due diligence on each of investment.
2. The “customer specific” suitability analysis requires that the firm to determine whether the security is suitable for the customer to whom it would be recommended. Brokerage firms are required to account for a client’s age, investment experience, net worth, and investment goals in determining whether an investment is appropriate for a particular client.
3. The “quantitative suitability” requires a broker who has actual or de facto control over a customer account to have a reasonable basis for excessively frequent transactions, and is not relevant to our business.

Rule 2111 also contains important modifications of the institutional investor exemption. A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in NASD [Rule 3110\(c\)\(4\)](#), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

### **Bottom Line**

You are required to gather comprehensive identifying information on all parties to your transactions. You are also required to collect suitability information for all non-institutional customers. Finally, you are required to conduct independent due diligence on each investment that you recommend prior to initiating transactions.



## SOURCE MATERIAL:

### CFR 103.122 – Customer Identification Programs for Broker-Dealers

**(a) Definitions.** For the purposes of this section:

**(1)** (i) *Account* means a formal relationship with a broker-dealer established to effect transactions in securities, including, but not limited to, the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral.

(ii) *Account* does not include:

**(A)** An account that the broker-dealer acquires through any acquisition, merger, purchase of assets, or assumption of liabilities; or

**(B)** An account opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974.

**(2)** *Broker-dealer* means a person registered or required to be registered as a broker or dealer with the Commission under the Securities Exchange Act of 1934 ([15 U.S.C 77a et seq.](#)), except persons who register pursuant to [15 U.S.C 78o\(b\)\(11\)](#).

**(3)** *Commission* means the United States Securities and Exchange Commission.

**(4)** (i) *Customer* means: (A) A person that opens a new account; and (B) an individual who opens a new account for: (1) An individual who lacks legal capacity; or (2) an entity that is not a legal person.

(ii) *Customer* does not include: (A) A financial institution regulated by a Federal functional regulator or a bank regulated by a state bank regulator; (B) a person described in § [103.22\(d\)\(2\)\(iii\)](#) through (iv); or (C) a person that has an existing account with the broker-dealer, provided the broker-dealer has a reasonable belief that it knows the true identity of the person.

**(5)** *Federal functional regulator* is defined at § [103.120\(a\)\(2\)](#).

**(6)** *Financial institution* is defined at [31 U.S.C. 5312\(a\)\(2\)](#) and (c)(1).

**(7)** *Taxpayer identification number* is defined by section 6109 of the Internal Revenue Code of 1986 ([26 U.S.C. 6109](#)) and the Internal Revenue Service regulations implementing that section (*e.g.*, social security number or employer identification number).



**(8) U.S. person** means: (i) A United States citizen; or (ii) a person other than an individual (such as a corporation, partnership or trust) that is established or organized under the laws of a State or the United States.

**(9) Non-U.S. person** means a person that is not a U.S. person.

**(b) Customer identification program: minimum requirements— (1) In general.** A broker-dealer must establish, document, and maintain a written Customer Identification Program (“CIP”) appropriate for its size and business that, at a minimum, includes each of the requirements of paragraphs (b)(1) through (b)(5) of this section. The CIP must be a part of the broker-dealer's anti-money laundering compliance program required under [31 U.S.C. 5318\(h\)](#).

**(2) Identity verification procedures.** The CIP must include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable. The procedures must enable the broker-dealer to form a reasonable belief that it knows the true identity of each customer. The procedures must be based on the broker-dealer's assessment of the relevant risks, including those presented by the various types of accounts maintained by the broker-dealer, the various methods of opening accounts provided by the broker-dealer, the various types of identifying information available and the broker-dealer's size, location and customer base. At a minimum, these procedures must contain the elements described in this paragraph (b)(2).

**(i) (A) Customer information required.** The CIP must contain procedures for opening an account that specify identifying information that will be obtained from each customer. Except as permitted by paragraph (b)(2)(i)(B) of this section, the broker-dealer must obtain, at a minimum, the following information prior to opening an account:

(1) Name;

(2) Date of birth, for an individual;

(3) Address, which shall be: (i) For an individual, a residential or business street address; (ii) for an individual who does not have a residential or business street address, an Army Post Office (APO) or Fleet Post Office (FPO) box number, or the residential or business street address of a next of kin or another contact individual; or (iii) for a person other than an individual (such as a corporation, partnership or trust), a principal place of business, local office or other physical location; and

(4) Identification number, which shall be: (i) For a U.S. person, a taxpayer identification number; or (ii) for a non-U.S. person, one or more of the following: a taxpayer identification number, a passport number and country of issuance, an alien identification card number, or the number and country of



issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

Note to paragraph (b)(2)(i)(A)(4)(ii): When opening an account for a foreign business or enterprise that does not have an identification number, the broker-dealer must request alternative government-issued documentation certifying the existence of the business or enterprise.

**(B) Exception for persons applying for a taxpayer identification number.** Instead of obtaining a taxpayer identification number from a customer prior to opening an account, the CIP may include procedures for opening an account for a customer that has applied for, but has not received, a taxpayer identification number. In this case, the CIP must include procedures to confirm that the application was filed before the customer opens the account and to obtain the taxpayer identification number within a reasonable period of time after the account is opened.

**(ii) Customer verification.** The CIP must contain procedures for verifying the identity of each customer, using information obtained in accordance with paragraph (b)(2)(i) of this section, within a reasonable time before or after the customer's account is opened. The procedures must describe when the broker-dealer will use documents, non-documentary methods, or a combination of both methods, as described in this paragraph (b)(2)(ii).

**(A) Verification through documents.** For a broker-dealer relying on documents, the CIP must contain procedures that set forth the documents the broker-dealer will use. These documents may include:

**(1)** For an individual, an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard, such as a driver's license or passport; and

**(2)** For a person other than an individual (such as a corporation, partnership or trust), documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.

**(B) Verification through non-documentary methods.** For a broker-dealer relying on non-documentary methods, the CIP must contain procedures that set forth the non-documentary methods the broker-dealer will use.

**(1)** These methods may include contacting a customer; independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from a consumer reporting agency, public database, or other source; checking references with other financial institutions; or obtaining a financial statement.



**(2)** The broker-dealer's non-documentary procedures must address situations where an individual is unable to present an unexpired government-issued identification document that bears a photograph or similar safeguard; the broker-dealer is not familiar with the documents presented; the account is opened without obtaining documents; the customer opens the account without appearing in person at the broker-dealer; and where the broker-dealer is otherwise presented with circumstances that increase the risk that the broker-dealer will be unable to verify the true identity of a customer through documents.

**(C) Additional verification for certain customers.** The CIP must address situations where, based on the broker-dealer's risk assessment of a new account opened by a customer that is not an individual, the broker-dealer will obtain information about individuals with authority or control over such account. This verification method applies only when the broker-dealer cannot verify the customer's true identity using the verification methods described in paragraphs (b)(2)(ii)(A) and (B) of this section.

**(iii) Lack of verification.** The CIP must include procedures for responding to circumstances in which the broker-dealer cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe:

**(A)** When the broker-dealer should not open an account;

**(B)** The terms under which a customer may conduct transactions while the broker-dealer attempts to verify the customer's identity;

**(C)** When the broker-dealer should close an account after attempts to verify a customer's identity fail; and

**(D)** When the broker-dealer should file a Suspicious Activity Report in accordance with applicable law and regulation.

**(3) Recordkeeping.** The CIP must include procedures for making and maintaining a record of all information obtained under procedures implementing paragraph (b) of this section.

**(i) Required records.** At a minimum, the record must include:

**(A)** All identifying information about a customer obtained under paragraph (b)(2)(i) of this section,

**(B)** A description of any document that was relied on under paragraph (b)(2)(ii)(A) of this section noting the type of document, any identification number contained in the document, the place of issuance, and if any, the date of issuance and expiration date;



**(C)** A description of the methods and the results of any measures undertaken to verify the identity of a customer under paragraphs (b)(2)(ii)(B) and (C) of this section; and

**(D)** A description of the resolution of each substantive discrepancy discovered when verifying the identifying information obtained.

**(ii) Retention of records.** The broker-dealer must retain the records made under paragraph (b)(3)(i)(A) of this section for five years after the account is closed and the records made under paragraphs (b)(3)(i)(B), (C) and (D) of this section for five years after the record is made. In all other respects, the records must be maintained pursuant to the provisions of 17 CFR [240.17a-4](#).

**(4) Comparison with government lists.** The CIP must include procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators. The procedures must require the broker-dealer to make such a determination within a reasonable period of time after the account is opened, or earlier if required by another Federal law or regulation or Federal directive issued in connection with the applicable list. The procedures also must require the broker-dealer to follow all Federal directives issued in connection with such lists.

**(5) (i) Customer notice.** The CIP must include procedures for providing customers with adequate notice that the broker-dealer is requesting information to verify their identities.

**(ii) Adequate notice.** Notice is adequate if the broker-dealer generally describes the identification requirements of this section and provides such notice in a manner reasonably designed to ensure that a customer is able to view the notice, or is otherwise given notice, before opening an account. For example, depending upon the manner in which the account is opened, a broker-dealer may post a notice in the lobby or on its Web site, include the notice on its account applications or use any other form of oral or written notice.

**(iii) Sample notice.** If appropriate, a broker-dealer may use the following sample language to provide notice to its customers:

#### Important Information About Procedures for Opening a New Account

To help the government fight the funding of terrorism and money laundering activities, Federal law requires all financial institutions to obtain, verify, and record information that identifies each person who opens an account.



What this means for you: When you open an account, we will ask for your name, address, date of birth and other information that will allow us to identify you. We may also ask to see your driver's license or other identifying documents.

**(6) Reliance on another financial institution.** The CIP may include procedures specifying when the broker-dealer will rely on the performance by another financial institution (including an affiliate) of any procedures of the broker-dealer's CIP, with respect to any customer of the broker-dealer that is opening an account or has established an account or similar business relationship with the other financial institution to provide or engage in services, dealings, or other financial transactions, provided that:

(i) Such reliance is reasonable under the circumstances;

(ii) The other financial institution is subject to a rule implementing [31 U.S.C. 5318\(h\)](#), and regulated by a Federal functional regulator; and

(iii) The other financial institution enters into a contract requiring it to certify annually to the broker-dealer that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's CIP.

**(c) Exemptions.** The Commission, with the concurrence of the Secretary, may by order or regulation exempt any broker-dealer that registers with the Commission pursuant to [15 U.S.C. 78o](#) or [15 U.S.C. 78o-4](#) or any type of account from the requirements of this section. The Secretary, with the concurrence of the Commission, may exempt any broker-dealer that registers with the Commission pursuant to [15 U.S.C. 78o-5](#). In issuing such exemptions, the Commission and the Secretary shall consider whether the exemption is consistent with the purposes of the Bank Secrecy Act, and in the public interest, and may consider other necessary and appropriate factors.

**(d) Other requirements unaffected.** Nothing in this section relieves a broker-dealer of its obligation to comply with any other provision of this part, including provisions concerning information that must be obtained, verified, or maintained in connection with any account or transaction.

[68 FR 25129, May 9, 2003]

## **Regulatory Notice 12-25. Know Your Customer and Suitability**

[http://finra.complinet.com/net\\_file\\_store/new\\_rulebooks/f/i/FINRANotice12\\_25.pdf](http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_25.pdf)



### **FINRA Rule 2090. Know Your Customer**

This rule was introduced with the filing of SR-FINRA-2010-039 which has been approved by the SEC.

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.

#### **Supplementary Material:**

(1) Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are 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.

### **FINRA Rule 2111. Suitability**

This rule was introduced with the filing of SR-FINRA-2010-039 which has been approved by the SEC.

(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.

(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in NASD [Rule 3110\(c\)\(4\)](#), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision-



making authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

## **Supplementary Material:**

### **(1) General Principles**

Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA's rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

### **(2) Disclaimers**

A member or associated person cannot disclaim any responsibilities under the suitability rule.

### **(3) Recommended Strategies**

The phrase "investment strategy involving a security or securities" used in this Rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities. However, the following communications are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities:

(a) General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile;

(b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

(c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable



investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with NASD [IM-2210-6](#) (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD [IM-2210-6](#); and

(d) Interactive investment materials that incorporate the above.

#### **(4) Customer's Investment Profile**

A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.

#### **(5) Components of Suitability Obligations**

Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

(b) The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).



(c) Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

#### **(6) Customer's Financial Ability**

Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities unless the member or associated person has a reasonable basis to believe that the customer has the financial ability to meet such a commitment.

#### **(7) Institutional Investor Exemption**

Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions delineated in that paragraph are satisfied. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.

