Fox Rothschild LLP
ATTORNEYS AT LAW

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

Prepared and presented by
Joshua Horn, Esq.
and the Securities Industry Group
215.299.2184
jhorn@foxrothschild.com

Table of Contents

Introduction

Now that you have secured a client relationship, the age-old question that every financial advisor 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 at the initiation of the client/advisor relationship rather than debated during a customer-initiated arbitration. Notwithstanding the importance of knowing your customer, all too often this information-gathering process is not given its proper weight.

This guide provides an overview of the information that should be gathered from every new client and maintained over the life of the client/advisor relationship. This guide also contains suggestions on how broker-dealers and registered investment advisors can improve their client account forms to ensure adequate “know your customer” intake. Conducting adequate fact-gathering protects you from potential liability, ensures that you make suitable investment recommendations and preserves good client relations.

What Information Should Be Gathered by the Financial Advisor?

The best way to approach the "know your customer" fact-gathering process is to develop and maintain a standard set of inquiries to make fact gathering second nature and more easily defended if questioned by a client. The following overlapping areas of inquiry (not necessarily in order of priority) 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 be said to know your customer and be able to make suitable investment recommendations.

Personal Information

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

1. Age.
2. Marital status.
3. Education (including the highest level attended).
4. Identity of all dependants 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, health care, etc.
9. Prior investing experience, which would also require an understanding of whether the person previously worked with a financial advisor or handled investment decisions exclusively on his/her own. If the person previously worked with a financial advisor, you should explore why the client is seeking to make a change.
10. Short-term and long-term goals for investment dollars.
11. Willingness to lose money over the short-term in exchange for long-term gain.
12. Hobbies/activities that require the expenditure of capital; e.g., travel, sporting/cultural events, etc.
13. Estate planning needs including, among other things, tax planning.

What Information Should Be Gathered by the Financial Advisor?

Financial Information

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

1. All sources of current income; i.e., employment, IRAs, pensions, 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 Information Should the Broker-Dealer/ Investment Advisor Collect?

The information that the financial advisor collects about a prospective client (and updates over the life of the relationship) will form the framework for the responses to questions typically posed on account opening questionnaires, which historically contained standard boxes for risk tolerance and investment objectives. As to risk tolerance, for example, these 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. Best practices suggest that the broker-dealer/investment advisor should couple these forms with more objective questionnaires that require more meaningful thought on the part of the customer as well as the financial advisor.

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/our investment dollars.
2. Over my/our investment time horizon of ___ years, I/we would like to earn an average annual return of ___%.

What Information Should the Broker-Dealer/ Investment Advisor Collect?

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/our 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/our investment time horizon of _______ years.

Although there are many permutations to the answers to these questions, the fundamental goal is to force the customer to provide his or her own assessment of investment objectives and tolerance for risk. These questionnaires should also contain a signature line below a certification, stating that the customer reviewed the form with the financial advisor and that the customer answered the questions in his/her own handwriting. By doing so, the claims of a disgruntled client that the advisor 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 the investment objectives and tolerance for risk.

Equally important, and separate and apart from the SEC Books and Records requirement to review client 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 advisor. 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/advisor relationship is for the financial advisor to know the customer and then make suitable investment recommendations. If a financial advisor does not approach the know-your-customer process with an adequate and consistent plan, the advisor 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 advisors with a framework to conduct the know-your-customer analysis and to better preserve client relations.

About the Author:
Joshua Horn, Esq., is a partner in the firm's Litigation Department and is co-chair of the Securities Industry Practice Group. He may be reached by telephone at 215.299.2184 or by e-mail at jhorn@foxrothschild.com.

www.foxrothschild.com