

State Protections For Vulnerable Investors Advance In 2019

By **Lawrence Fenster and Andrew Mount** (December 9, 2019)

The North American Securities Administrators Association's Model Act to Protect Vulnerable Adults from Financial Exploitation or similar protective measures have now been adopted in 27 states through legislation or regulation.

As of year-end 2019, Arizona, California, New Hampshire, Maine, Rhode Island and Virginia have passed these report and hold laws, and two states — Wisconsin and Michigan — have introduced similar bills. Bills failed to pass in Missouri and New Jersey, and for the second consecutive year in Florida and Washington, D.C.

The Model Act requires broker-dealers and state-registered investment advisers to report suspected financial exploitation of senior and vulnerable investors to state agencies. The Model Act permits firms to temporarily withhold the disbursement of funds when exploitation is suspected.

In addition, the Model Act allows firms to communicate with a contact person designated by the customer, when needed, as part of its investigation into the suspected exploitation. States that have adopted report and hold laws have frequently modified the provisions of the Model Act depending upon individual statewide considerations.



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Expanding the Scope of Report and Hold Laws to Cover Transactions

Under the Model Act and Financial Industry Regulatory Authority Rule 2165, which resembles many of the Model Act's provisions, a broker-dealer can place a temporary hold only on disbursements, not transactions. In part, the stated rationale is that stopping transactions hinders the autonomy of senior investors from making their own independent investment decisions, and could conflict with broker-dealer best execution duties under FINRA Rule 5310.

In August, FINRA issued Regulatory Notice 19-27, which asked for comment on a revision to Rule 2165 that would allow firms to make temporary holds on securities transactions.

An increasing number of states' report and hold laws include holds on transactions as well as disbursements. Arizona, California and Virginia, for example, enacted a transaction hold provision in their 2019 laws.

In 2017 and 2018, Minnesota, Utah, Kentucky, Mississippi, New Mexico, North Dakota and Texas expanded upon the Model Act's immunity provision to allow firms to place a hold on suspicious transactions related to financial exploitation, even as Delaware amended its law to exclude transactional holds.

Extending Safe Harbor Periods to Allow Thorough Internal Investigations

The limited safe harbor provided for by the Model Act and FINRA Rule 2165 allows firms to freeze a suspicious disbursement for up to 15 business days from the date of the hold on the disbursement. If the firm's internal review confirms suspicions about exploitation, the

hold may be extended for another 10 business days, unless otherwise terminated or extended by a state regulator, agency or court.

Firms seeking to rely on FINRA Rule 2165 and state laws have noted, however, that in practice, 25 business days is often too short a period to complete an internal investigation into the suspected exploitation. In response, in Regulatory Notice 19-27, FINRA has asked for comment on a revision to Rule 2165 that would extend the time that a firm can place a temporary hold.

Some states have provided firms with longer time intervals to complete their review and still retain immunity. Eleven states (Arizona, Colorado, Delaware, Kentucky, Louisiana, Maryland, Minnesota, New Mexico, North Dakota, Tennessee and Utah) permit state agencies to extend the hold period without the need for a court order. The remaining 16 states with report and hold laws only provide for an extension through court order.

The trigger date to measure the hold period, the permissible length of the hold period, and the potential for extensions of the period vary considerably from state to state. Consider the following examples:

- Washington permits a hold of up to 5 business days after the placement of the hold if the disbursement is not related to the sale of a security. Notably, this is the shortest hold period in the country. If the requested disbursement is related to a securities transaction, the temporary hold may last up to 10 business days. The hold can only be extended by court order.
- Delaware allows an initial hold period of up to 10 business days. Firms may then extend the hold for an additional 30 business days, if requested to do so by the securities commissioner, or if the firm does not receive feedback from state agencies. The securities commissioner can extend the hold beyond the 40-day window.
- Virginia provides that a hold can be placed for an initial period of up to 30 business days, commencing from the date the suspicious request was made, not the date the disbursement hold is placed. No extensions are permitted absent court order.

Permitting State Agencies to Share Information

Firms report that they are frequently unable to receive timely reports from state adult protective services, or APS, agencies regarding the status of an investigation. To address states' privacy concerns, some states have taken steps to permit their agencies to share information.

Kentucky, for example, expressly allows its agencies to report back to the reporting firm regarding the status of their investigations. Similarly, California allows its agencies to provide information to the reporting firm.

A limited number of APS statutes make it mandatory that agencies provide updates to reporting firms. Georgia, for example, requires its APS agency to respond to a reporting firm within five business days, and disclose whether an investigation was initiated and whether the investigation remains open.

Connecticut requires that its APS agency disclose the results of its investigation to the firm within 45 days after its completion of the investigation.

Adding Third-Party Contacts

The Model Act and 11 states (Alaska, Arkansas, California, Delaware, Louisiana, Maine, Maryland, Minnesota, New Hampshire, Oregon and Vermont) permit firms to notify those individuals previously designated by the senior or vulnerable investor of suspected financial exploitation. New Mexico requires firms to attempt to notify third parties previously designated by the eligible adult.

These provisions are similar to the approach in FINRA's Rule 4512 — i.e., that the firm must make reasonable efforts to obtain contact information for a designated trusted contact person when opening new accounts, when updating account information in the normal course of their business, or as otherwise required by law.

Following the placement of a temporary hold, FINRA Rule 2165 further requires that the firm notify the trusted contact person and all parties authorized to transact business on the account.

Frequently, a senior either may not have designated a contact or the trusted contact person is unwilling or unable to provide useful information. At times, the trusted contact person may also be the suspected bad actor. This limits the value of having a designated person to receive notice of financial exploitation.

Persons other than the designated contact person — relatives, friends or neighbors — may, however, be able to provide facts useful to complete the investigation.

To address this, 10 states (Alabama, Arizona, Colorado, Mississippi, Montana, New Mexico, North Dakota, Texas, Kentucky and Utah) have created more practical tools to protect potentially vulnerable clients by broadening the permissible class of contacts.

In addition to the ability to notify a designated contact, these states allow firms to contact anyone reasonably associated or closely connected to the customer.

This expanded approach mimics the exception to Regulation S-P's notice provision for information sharing to "protect against or prevent actual or potential fraud, unauthorized transactions, claims, or other liability."

Dealing with Different Reporting Obligations

In certain states, there is a conflict in reporting obligations between Model Act-derived reporting provisions and those contained in state APS statutes.

For example, 10 states (Arizona, Louisiana, Kentucky, Missouri, Minnesota, Montana, New Hampshire, Tennessee, Virginia and Washington) did not adopt the Model Act's mandatory reporting requirement in their report and hold laws. Of those, however, firms doing business in Arizona, Louisiana, Tennessee and Kentucky are still required by the APS laws of those states to report financial exploitation.

For example, Arizona's APS statute requires "any person who is responsible for any action concerning the use or preservation of a vulnerable adult's property" to immediately report exploitation of a vulnerable adult to a protective services worker, a peace officer or to the

county public fiduciary. Arizona's 2019 report and hold law permits firms to report financial exploitation of a vulnerable or senior adult to APS and the Securities Division of the Arizona Corporation Commission.

The opposite fact pattern is found in nine states (Alabama, Alaska, California, Colorado, Oregon, Maine, Maryland, North Dakota and Vermont). These states have APS laws that do not require firms to report financial exploitation, but whose report and hold laws do require reporting to be made by firms.

For example, Maryland's APS statute permits any individual to report suspected exploitation to the local health department, while Maryland's report and hold law requires reporting to be made by the firm to the securities commissioner and the local health department.

When a state has differing reporting provisions, the statutes should be read together in favor of requiring the filing of a report.

Conclusion

By expanding the report and hold laws to cover suspicious transactions as well as disbursements, extending the time frame for hold periods to permit more extensive firm investigations, and broadening the range of individuals who may be contacted in connection with a firm's investigation, states are increasingly providing firms with more effective options for fighting the financial exploitation of senior and vulnerable investors.

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