As Appeared in the ABA Securities Litigation Summer of 2019 Volume 29, Issue 3

2019 Midyear Update on Senior and Vulnerable Investor Legislation

States are Increasingly Providing Firms with More Effective Options for Fighting Financial Exploitation of Senior and Vulnerable Investors.

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Three years after the North American Securities Administrators Association (NASM) passed an Act to Protect Vulnerable Adults from Financial Exploitation, 24 states have adopted the model act or similar protections through legislation or regulation (referred to as "report and hold laws"). In 2019, the state legislatures of Arizona, Maine, and Virginia have passed these laws, while California, New Hampshire, New Jersey, and Washington, D.C. have pending report and hold legislation.

The model act requires broker-dealers and state-registered investment advisers to report suspected financial exploitation of senior and vulnerable investors to state agencies. It also 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 adopting report and hold laws have made six primary changes to the model act.

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1. Expanding the Scope of Report and Hold Laws to Cover Transactions

Under the model act and the Financial Industry Regulatory Authority's (FINRA's) Rule 2165 (which resembles many of the model act's provisions), a broker-dealer can place a temporary hold only on disbursements, not transactions. Although FINRA suggested in its Regulatory Notice 17-11 that it may, in future rulemaking, revise Rule 2165 to include transactions, neither the model act nor FINRA's Rule 2165 provides firms with a safe harbor period for transaction holds. In part, the stated rationale is that stopping transactions hinders the autonomy of senior investors in making their own independent investment decisions and could be in conflict with the "best execution" duties under FINRA Rule 5310.

Although allowing holds on disbursements is a powerful tool to counter financial exploitation, expanding holds to cover transactions provides more comprehensive investor protection. For example, disbursement holds do not prevent bad actors from influencing vulnerable investors to change account ownership, name new beneficiaries, purchase an ill-advised investment, liquidate long-held securities positions (with significant capital gains implications), or terminate annuities with associated financial penalties.

Long before a suspected inappropriate disbursement request is even made, a transactional hold can stop an exploited senior or vulnerable investor from incurring significant costs, penalties, and tax consequences. As Missouri's securities commissioner, David Minnick, stated in an interview, "placing a temporary pause on a transaction protects vulnerable investors from making irreversible investment decisions that they subsequently may regret."

Given these concerns, an increasing number of states favor report and hold laws that recognize the need for transaction as well as disbursement holds. Arizona and Virginia enacted a transaction hold provision in their 2019 laws. In 2018, Kentucky, Minnesota, and Utah expanded on 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. Mississippi, New Mexico, North Dakota, and Texas adopted transactional holds in 2017. California and New Jersey will join the other nine states that permit transactional holds if their 2019 bills pass.

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2. 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.

The model act did not extend immunity for holds (absent a court order) beyond the 25-business-day period due to concerns expressed by consumer advocates. These included concerns that a longer hold period could result in bounced check fees, missed bill payments, and other investor financial hardships.

Firms seeking to rely on FINRA Rule 2165 and state laws have noted, however, that in practice it frequently takes longer than 25 business days to complete an internal investigation into the suspected exploitation. Investigations taking longer than the allotted time frame are often the result of certain limitations on a firm's investigation-gathering process - firms do not have subpoena power, may not be able to share information about a mutual customer with other firms, and sometimes have difficulty in obtaining timely and complete information from state adult protective services (APS) agencies. Erin Linehan, Associate General Counsel-Compliance of Raymond James, says that "these limitations on a firm's information gathering allow only a small percentage of investigations to be resolved in the allotted timeframe."

To help firms with their investigations, 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 13 states with report and hold laws provide for an extension on the specified time frame only 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:

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- 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 following the start of the hold. The hold can be extended only 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 also extend the hold beyond the 40-day window.

- Utah permits an initial I5-business-day hold. State agencies can permit the firm to extend the hold for as long as reasonably necessary, as long as the firm's internal review supports its suspicion of exploitation.

- 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 intervention.

- Missouri's law, adopted prior to the model act, permits a disbursement hold for up to 10 business days from the date the firm places the hold. The hold may be extended by a court order only.

3. Permitting State Agencies to Share Information

Firms report that they are frequently unable to receive timely reports from state APS agencies regarding the status of an investigation. Some states simply will not provide this information, citing privacy and confidentiality laws. Others attribute their inability to respond to more exigent concerns, such as reports of actual or threatened physical abuse of seniors.

To address the privacy concerns, some states have taken steps to permit their agencies to share information. Kentucky expressly allows its agencies to report back to the reporting firm regarding the status of their investigations. Similarly, proposed legislation in California would allow the agencies to provide information to the reporting firm. New Jersey's current bill requires its securities division to respond to reasonable inquiries regarding the status of the agency's investigation and, upon conclusion of the investigation, to issue a statement of findings to the reporting firm.

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A limited number of APS statutes require agencies to provide updates to reporting firms. Georgia, for example, requires its APS agency to respond to a reporting firm within 5 business days and disclose whether an investigation was initiated and whether the investigation remains open. Connecticut mandates that its APS agency disclose the results of its investigation to the firm within 45 days after its completion of the investigation. Mississippi's APS agency is required to advise the firm if the agency is taking any action.

4. Adding Third-Party Contacts

The model act and nine states (Alaska, Arkansas, Delaware, Louisiana, Maine, Maryland, Minnesota, 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.

According to the commentary to the model act, the limited scope of the provision reflects the opinion that, "[t]o the greatest possible extent, seniors and other vulnerable adults should themselves be making decisions about whom a financial services professional should contact in the event of suspected financial exploitation." Joseph Brady, NASM's executive director, noted in an interview that the limited scope of third-party notification "balances investor protection with rights to privacy, self-determination and personal autonomy." The provision attempts to "respect the familial relationship, but also tries to make sure the firm has someone to contact when exploitation is suspected."

These provisions are similar to the approach in FINRA's Rule 4512, i.e., that the firm must make reasonable efforts to obtain a designated trusted contact person when opening new accounts or when updating account information in the normal course of its 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, either a senior has not designated a contact or the trusted contact person is unwilling or unable to provide useful information. Of course, 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.

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Persons other than the designated contact person-relatives, friends, or neighbors-may, however, be able to provide facts useful to complete the investigation. Thomas Mierswa, executive director with Morgan Stanley's legal department, believes that in these scenarios, "an expanded third party contact provision would provide firms with a more practical tool to protect clients when they may be most vulnerable."

To address this, 10 states (Alabama, Arizona, Colorado, Kentucky, Mississippi, Montana, New Mexico, North Dakota, Texas, and Utah) have created more practical tools to protect potentially vulnerable clients by broadening the permissible class of contact persons. In addition to the ability to notify a designated contact, these states allow firms to contact anyone "reasonably associated" with 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." New Jersey's pending bill would also allow communications with individuals "reasonably associated" with the customer.

5. Creating Different Reporting Obligations

Nine states (Arizona, Kentucky, Louisiana, Minnesota, Missouri, Montana, Tennessee, Virginia, and Washington) did not adopt the model act's reporting requirement in their report and hold laws. Firms doing business in Arizona, Kentucky, Louisiana, and Tennessee 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 the county public fiduciary, and is not limited to broker-dealers or registered investment advisers. The statute does not specifically cover exploitation of seniors. 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 Corporation Commission.

The opposite fact pattern is found in eight states (Alabama, Alaska, Colorado, Maine, Maryland, North Dakota, Oregon, and Vermont). These states have APS laws that do not require firms to report financial exploitation, but their report and hold laws do require reporting to be made by firms. For example, Maryland APS statute permits any individual

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to report suspected exploitation to the local health department, while the state'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.

6. Broadening Report and Hold Laws to Other Financial Institutions

In addition to the report and hold laws that apply to broker-dealers and investment advisers, a growing number of states allow a broader range of financial institutions to place temporary holds. In 2017, Texas passed parallel report and hold legislation that applies to commercial banks, savings and loan associations, and credit unions. The Texas law permits a temporary hold on transactions and disbursements under certain circumstances. In 2019, Montana and Virginia enacted legislation that permits commercial banks, trust companies, savings and loan associations, and credit unions to place a temporary hold on disbursements and transactions. Washington D.C.'s pending legislation would also allow a broad range of financial institutions to place holds on suspicious disbursements.

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 for more extensive investigations by firms, 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 financial exploitation of senior and vulnerable investors. Thus far, the trend of new state laws, although slow-moving, appears to be in the direction of providing increasingly more latitude to firms to provide protection for their senior and vulnerable investor clients.