Senior Investors: What You Need to Know

January 16, 2018

Senior Investors
Speaker

- Morris Simkin
- Law Office of Morris Simkin
- 60 E. 42d Street, Suite 1101
- New York, New York 10165
- 212 455 0476
- msimkin@securitiesregslawyer.com

Overview

- Everybody wants to get in to the act
- SEC:		Enforcement priority
- FinCEN Customer Information Program
- FINRA	Rules- Suitability
  - **Know Your Customer**
  - **Withholding funds in cases of "financial exploitation**"

  NASAA Model Legislation

SEC Enforcement

- Enforcement Division 2017 Report
  - Establish Retail Strategy Task Force
    - Focus on offering frauds involving the retail investor
    - Use technology and data analytics to identify large scale wrongdoing

Suitability

- The Suitability Rule applies whenever a broker **recommends** a **transaction or investment strategy** to a **customer** based upon the customer's **investment profile**
- Four key terms that need definition before we can understand the rule

SEC

- Exchange Act Rule 17a-3(a)(17)
- Brokerage firm must maintain for each account of a natural person- name, tax identification number, address, age, phone number, occupation, and investment objective
- Must send notice confirming this at opening of account and every 3 years thereafter with note telling customer to update or correct it
- Applies if at opening or within 3 years broker had to make a suitability determination

FINRA
Know Your Customer

- Rule 2090
- Know the essential facts when opening a customer's account
  - The facts necessary to service the account
  - Who has authority over the account
  - Any special handling instructions
  - Comply with applicable law

FinCEN Customer Identification Program

- FinCEN Rule 31 CFR 1023.220 requires brokerage firms to establish a customer identification program
  - Individual's name, address, date of birth and tax identification number
  - Verify this either by documents (e.g. driver's license or passport) or non-documentary- contact customer directly, check public data bases, etc.
  - Notice to customer you are verifying their identity

FINRA Suitability Rule

- FINRA Rule 2111- a recommended transaction should be suitable for a customer
- Simple concept and hard to argue with
  - but extremely complex application
  - FINRA has published 5 Regulatory Notices, a Frequently Asked Question and a sample account opening form. FINRA will issue a new Regulatory Notice on this rule in 2018

Customer

- Anyone who has or opens an account with the broker or effects transaction with a broker- either directly or where the broker receives compensation because the customer effected a transaction
  - e. g. private placement or bought a no-load mutual fund that pays 12b-1 fees

  And the broker either a) recommends the transaction, b) recommends the investment strategy, or c) recommends holding a security

Customer

- Example: broker sends research or recommends a security to a friend who effects a trade in that security with the broker. If the friend executes the trade elsewhere, there is no “customer” relationship

Recommend

- This is a facts and circumstances test
- Did the content, context and presentation of a communication or series of communications to a person involve a call to action or suggest that the person engage in a securities transaction
- It also includes an affirmative recommendation to hold a security or to follow a specific investment strategy

Recommend

- An implicit recommendation is also a recommendation triggering a suitability obligation
- Effecting a transaction pursuant to the exercise of discretionary authority or without first informing the customer are implicit recommendations

Investment Strategy

- Any strategy involving the purchase, sale or holding of a security
  - Incudes: trade on margin, day trading, using a home equity loan to fund trading
  - Includes strategies that involve trading in securities- e.g. buy an index futures contract and sell the related securities

Investment Profile

- A customer's investment profile consists of:
  - Customer's age
  - Other investments
  - Financial situation and needs
  - Tax status
  - Investment objectives
  - Investment experience
  - Investment time horizon
  - Liquidity needs
  - Risk tolerance
  - Information the customer supplies to the broker
  - Investment income and capital sources for trading

Suitability Tests

- Rule 2111 states 3 tests to be met in determining whether a transaction is suitable:
  - 1. Reasonable basis for the recommendation;
  - 2. Customer specific recommendation; and
  - 3. Quantitative suitability.

  FINRA has stated a fourth test– does the recommendation favor the broker over the customer

Reasonable Basis

- A recommendation has a "reasonable basis" when the broker, based upon reasonable due diligence, has a reasonable basis to believe that the recommended security or investment strategy is suitable for at least some customers
- "reasonable basis" means the broker him/herself understands the security /strategy and its risks and rewards
  - It is not enough for the security to be approved by the firm if the broker does not also understand the security/strategy

Customer Specific

- The broker has obtained or used reasonable diligence to obtain the customer’s investment profile, and, based thereon, has a reasonable basis to believe that the recommendation is suitable for the specific customer

Quantitative Specific

- The broker with actual or de facto control over a customer account has a reasonable basis to believe that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive or unsuitable for the customer when taken together in light of the customer's investment profile

Reasonable Diligence

- Broker uses reasonable diligence when s/he asks the customer for the information (and documents the request and reply or lack of reply)
- Suitability rule does not impose a duty to update, except to the extent the customer gives the broker new information
- But Exchange Act rule 17a-3(a)(17) [see before] imposes a firm duty to ask the individual customer every 3 years

Reasonable Diligence

- If the request for information is not clear or the customer shows an inability to understand or reply or there are other “red flags,” the broker has not exercised reasonable diligence

Reasonable Diligence

- If one or more items of the customer profile are missing, broker cannot act on the basis of any assumptions or impressions (s)he has abut the customer regarding the missing item(s)
- The broker can make a risk based assessment of the need for the missing information in order to determine a recommendation's suitability

Customer Financial Ability

- Can’t recommend a transaction or investment strategy to a customer unless broker has a reasonable basis to believe that the customer has the financial ability to meet such commitment

Suitability

- The broker has an obligation to act in the customer’s best interest
- Suitability rule requires the broker to make only those recommendations that are consistent with the customer’s best interest
- It prohibits a broker from placing his or her interests ahead of the customer’s interest
  - No switching to generate commissions
  - No favoring one product or class of product because it pays a higher commission
  - No churning

Suitability Rule Limited Exemption

- Exemption does not include reasonable basis and the quantitative test
- Exemption is for recommendations to an “institutional investor” (Customer has over $50 million in assets) if
  – Broker reasonably believes the client is capable of exercising independent judgment
  – Customer affirmatively indicates it is exercising independent judgment

FINRA Financial Exploitation of Seniors

- Effective February 5, 2018 new FINRA Rule 2165 and amendments to Rule 4512 will allow firms to withhold sale proceeds or delivery of securities for up to 25 business days if there is a reasonable basis to believe a specified person is over 65 or over 18 and unable to fend for themselves has been or will be the victim of financial exploitation

Rule 4512

- When opening an account and when periodically updating an account's information, the firm is to ask a specified customer the name and contact information for a "trusted contact person" who is over 18
  - Customer can refuse to furnish this, and firm can still open/maintain the account
  - Firm must notify customer that it is authorized to contact the trusted contact person and disclose account information if there is suspected financial exploitation

Rule 2165

- Applies to accounts of individuals that are either a) over 65 or b) whom the firm believes has a mental or physical impairment preventing them from protecting their interests
- Financial exploitation means: a) wrongful or unauthorized taking or using a person’s funds or securities; or b) any act or omissions to obtain control, through deception, intimidation or undue influence to obtain control or convert a person’s money, assets or property

Rule 2165

- If firm believes financial exploitation has occurred, is occurring or will occur it can notify the Trusted Contact Person, within 2 business days, and hold disbursement of funds and securities for up to 15 business days. This can be extended another 10 business days
- The firm must immediately conduct an internal review of the facts and circumstance that led it to believe there was financial exploitation

Rule 2165

- The firm must have in place written supervisory procedures to achieve compliance with Rule 2165, and training policies so its brokers can comply with the rule

NASAA Model Legislation

- NASAA has proposed model legislation tracking Rule 2165
- The legislation would grant immunity to firms and individuals reporting financial exploitation to the securities administrator
- The legislation would allow delaying disbursements from an individual's account if there is a reasonable belief of financial exploitation and grant immunity for such delay if the broker acted in good faith

AML Rule Amendment

- FinCEN amended the anti-money laundering rules to add a fifth element
- This element requires firms to adopt risk based procedures to conduct ongoing customer due diligence

Ongoing Due Diligence

- These risk based procedures include:
  - A) understanding the nature and purpose of the customer relationship for the purpose of developing a customer based profile
    - What types of transactions would a customer normally be expected to engage in
    - This requires obtaining basic customer information as well as information that is self-evident to the broker

Ongoing Due Diligence

- B) ongoing monitoring of the account to identify and report suspicious transactions and to maintain and update customer information, including changes in beneficial owners

Monitoring

- The customer risk profile is the information gathered about a customer to develop a baseline against which customer activity is assessed for suspicious activity reporting
- No special monitoring of customer activity is intended to be required by this
- The duty to update the beneficial ownership is triggered when in the course of normal monitoring the broker detects information relevant to assessing the risk posed by the customer. It is not a requirement to periodically verify or update.

Monitoring

- The update requirement is triggered by information received during the normal course of monitoring an account