When the Baby Boom Era Becomes the Retirement Explosion

A Securities Compliance Professional's Guide to Protecting Her Firm and Senior Customers

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# TABLE OF CONTENTS

## I. INTRODUCTION .....................................................................................................................................................1

## II. DUTIES OWED TO SENIOR CUSTOMERS........................................................................................................1

   A. Broker-Dealers..................................................................................................................................................1
      1. Non-discretionary accounts........................................................................................................................................2
      2. Discretionary accounts ........................................................................................................................................2
      3. Formal classification of the account does not always matter ..................................................................................2
   B. Investment Advisers..............................................................................................................................................3
   C. Elder Abuse Statutes..............................................................................................................................................3
      1. Statutes of general application................................................................................................................................3
      2. Statutes specifically addressed to financial abuse of the elderly and vulnerable ..............................................4
      3. Statutes enhancing penalties for crimes against the elderly and vulnerable victims ...........................................4

## III. REGULATORY CONCERNS ABOUT SALES PRACTICES AND THE SALE OF CERTAIN PRODUCTS TO SENIORS........................................................................................................5

   A. Variable Annuities ................................................................................................................................................5
      1. NASD proposed Rule 2821 .....................................................................................................................................5
         a. History of the proposed Rule ..............................................................................................................................5
         b. NASD Amendment nos. 3 and 4 ........................................................................................................................6
         c. Proposed Rule 2821 in its current form ................................................................................................................6
      2. Model rules regulating insurance companies ....................................................................................................8
   B. Life Settlements .....................................................................................................................................................9
      1. Background .........................................................................................................................................................9
      2. Problems in the industry ......................................................................................................................................9
      3. Model regulations and NASD Notice to Members 06-38 ...................................................................................9
   C. Equity-indexed Annuities .......................................................................................................................................10
      1. Background ......................................................................................................................................................10
      2. Are EIAs securities? ...........................................................................................................................................11
      3. State regulation ................................................................................................................................................11
   D. Advertising and Marketing .....................................................................................................................................11
      1. Free lunch sales seminars ...................................................................................................................................12
      2. Senior specialists ..............................................................................................................................................12
      3. Other examples of misleading advertising and marketing materials .....................................................................13
   E. Point of Sale Disclosures ......................................................................................................................................14
      1. SEC proposals ..................................................................................................................................................15
         a. Content and format ...........................................................................................................................................15
         b. Oral disclosure of point of sale information .........................................................................................................15
         c. Timing of point of sale disclosure .......................................................................................................................16
         d. Exceptions to point of sale disclosure requirements ........................................................................................16
         e. Special issues for variable products ..................................................................................................................16
      2. The NASD Mutual Fund Task Force ................................................................................................................16
         a. Point of sale disclosure through the Profile Plus ..............................................................................................16
         b. Mutual fund fee structure disclosure ................................................................................................................17
         c. Rule 12b-1 concerns and issues .......................................................................................................................17
         d. Mutual fund share classes ................................................................................................................................18
   F. Selling Away and Fraudulent Schemes ...................................................................................................................18
      1. Selling away .....................................................................................................................................................18
      2. Ponzi and pyramid schemes ............................................................................................................................19
      3. Fraudulent investment schemes and seniors ....................................................................................................20

## IV. SUGGESTED BEST PRACTICES..........................................................................................................................20

   A. Training ...............................................................................................................................................................21
   B. Cooperation with Family and Other Professionals ...............................................................................................21
   C. Written Materials, Typeface, Type Color ..............................................................................................................21
   D. Monitoring of and Cooperation with AARP and Similar Lobbies ..........................................................................21
   E. Supervision of Seminars and Advertising ...........................................................................................................22
   F. New Account Information and Review and Updating of Same .............................................................................23
   G. Principal/Supervisory Responsibility ...................................................................................................................23
   H. Other Written Policies and Procedures to Consider ............................................................................................23
   I. Specialized Surveillance Tools and Exception Reports ...........................................................................................24

## V. CONCLUSION ..........................................................................................................................................................24
1. INTRODUCTION

If the period between 1946 and 1964 is considered the “Baby Boom Era,” the next two decades can easily be classified as the “Retirement Explosion.” During the next 20 years, it is estimated that 10,000 Americans will turn 60 every 24 hours. Individuals aged 50 and above currently account for approximately 75 percent of the total financial assets in the country and head approximately 75 percent of the households.3

Unfortunately, this dramatic growth in the number of seniors with investable assets has led to a disturbing trend. Studies show that over 30 percent of investment fraud victims are seniors.4 Senior investors also account for nearly 75 percent of fraud victims in states, such as Florida, that tend to have a large retiree population.5 According to regulators and investors, the schemes not only are carried out by non-certified individuals and companies, but also by certified individuals, broker-dealers and investment advisers.6 Of even more concern to the regulators, however, is the projection that these percentages may increase as the baby boomers continue to retire.7

The regulators have also conducted studies that indicate certain groups of seniors are vulnerable to particular sales pitches, methods, and techniques.8 The studies have led to a combined effort to monitor sales techniques traditionally associated with investment fraud schemes. For example, regulators have conducted recent sweeps of free lunch sales seminars, they have expressed concern over the use of professional designations such as “Senior Specialist,” and they have made efforts to ensure that investment professionals market investments and strategies to seniors that are suitable for them. These initiatives and efforts will have a significant effect on financial services firms and their supervisory and compliance professionals.

Regulators continue to bolster their efforts to hold firms accountable for not properly supervising communications to seniors about investment products and strategies that may not be suitable for seniors. In addition, regulators are sanctioning firms that fail to ensure that their registered persons thoroughly inform senior investors of not only the advantages, but also the disadvantages, associated with various products and investment plans.

Not surprisingly, the regulators’ heightened focus on protecting seniors has coincided with an increase in private actions brought by senior investors against financial services firms. Moreover, this regulatory focus has led to Congressional and state legislative interest, resulting in the creation of elder abuse statutes. The plaintiffs’ bar already has utilized, and will continue to utilize, these new laws and regulations in their private actions against firms selling investments and advisory services to seniors.

This White Paper discusses the most significant and prevalent seniors issues that now face, or are on the horizon for, compliance professionals in broker-dealer and investment advisory firms. The first portion of this White Paper outlines the legal duties and regulatory obligations registered representatives and investment advisers owe to investing seniors. It will then discuss the significant issues that currently are the focus of the regulators’ attention and that should be the focus of compliance professionals’ efforts. This White Paper will then provide practical guidance and identify suggested “best practices” for policies and procedures that compliance professionals should consider adopting and implementing in order to help protect their firms and senior investors from illicit schemes and inappropriate and unlawful sales practices.9

II. DUTIES OWED TO SENIOR CUSTOMERS

A. Broker-Dealers

A broker owes duties of diligence and competence in executing a client’s trade orders and should give honest and complete information when recommending the purchase or sale of securities. Courts have held that a broker’s basic duties include: (1) a duty to refrain from self-dealing; (2) a duty to recommend an investment after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (3) a duty to recommend only investments which are suitable for the customer

3. Id. at 18.
4. Id. at 13.
5. Id. at 14-15.
6. Id. at 15-16.
7. Id. at 14.
9. Although beyond the scope of this White Paper, it is worth noting that in 2006, the U.S. Securities and Exchange Commission (“SEC”) commissioned the RAND Corporation to conduct a study “comparing the levels of protection afforded retail customers of broker-dealers and investment advisors” so that the SEC may evaluate “the current legal and regulatory environment for the provision of financial products, accounts, programs, and services to senior investors by broker-dealers and investment advisers.” Testimony of Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n, Before the Special Committee on Aging, United States Senate (September 5, 2007).
based on the customer’s investment objective, financial status, tax status, and other criteria (the “Suitability” and “Know Your Customer” rules); (4) a duty to transact business only after receiving customer authorization; (5) a duty not to misrepresent material facts, including facts about the securities recommended, the risks involved or the ability of the customer or the broker to limit these risks, the broker’s commissions, and the broker’s claimed possession of inside information; (6) a duty to observe all industry rules, regulations, customs, and practices, including internal policies and procedures intended to protect the customer; and (7) a duty to carry out the customer’s orders promptly, in a manner best suited to serve the customer’s interests, and at the best reasonably available price. These duties can change depending on various factors including the type of account (discretionary vs. non-discretionary), the sophistication of the client, and the relationship between the client and the registered representative.

1. Non-discretionary accounts

Courts typically look to the type of account to determine the scope of the duty owed. With a non-discretionary account, the broker owes the customer the conventional duties outlined above with respect to each transaction only. For example, the courts have held that the customer has no legal claim on the broker’s ongoing attention, and the giving of advice generally triggers no duty to do so going forward.

Where the customer is inexperienced or unsophisticated with regard to financial matters, the broker should carefully and completely define the potential risks of a transaction. On the other hand, the broker’s explanation of such risks may be perfunctory if the customer purports to understand the stock market or is personally familiar with the security. Generally speaking then, registered representatives owe limited duties to their customers with respect to non-discretionary accounts.

2. Discretionary accounts

In contrast to non-discretionary accounts, if a broker exercises some sort of control over the customer’s account, the broker likely will have broader, ongoing duties to the customer. Where the broker either has the authority to make (e.g., power of attorney or written grant of discretion), or in fact makes purchase and sale decisions without specific prior authorization from the customer, courts have held that the broker becomes a fiduciary of the customer in the broadest sense. The implication is that the broker has duties that extend beyond each transaction, including possibly the duty to:

(1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer’s investment history; (2) keep informed regarding changes in the market which affect his customer’s interest and act responsibly to protect those interests; (3) keep his customer informed as to each completed transaction; and (4) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.

These duties are in addition to the duties discussed above for non-discretionary accounts.

3. Formal classification of the account does not always matter

It is important to note that the technical name given to the account (either discretionary or non-discretionary) does not always dictate the duties owed to the customer. Occasionally, courts have held that a broker has assumed actual control over a non-discretionary account. In such cases, the courts have held that the broker is the customer’s fiduciary from the moment the broker assumed control of the account.

In determining whether a broker has assumed control over a non-discretionary account, the courts weigh several factors. First, the courts evaluate the age, education, intelligence and investment acumen of the customer. If the customer is particularly young, old, or naive with regard to financial matters, the courts might find that the broker assumed de facto control over the account.

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12 Leib, 461 F. Supp. at 952.
13 Id. at 953.
14 See, e.g., De Kwiatkowski, 306 F.3d at 1302.
15 Id.
16 Id.
17 Leib, 461 F. Supp. at 953.
18 Id.
19 Id.
20 Id.
21 Leib, 461 F. Supp. at 954.
account.\textsuperscript{22} For example, one court found that a broker sufficiently controlled the non-discretionary account of a 77 year old widow because she was relatively naïve and unsophisticated and invariably relied on the broker’s recommendations.\textsuperscript{23}

Courts have used a variety of phrases to describe the duties that a broker owes to his clients (e.g. fiduciary, loyalty, reasonable care, full disclosure, and good faith). As discussed above, the specific facts determine the duty owed: the type of account, the broker’s or client’s control over that account, the relationship between broker and customer and the customer’s sophistication. In sum, function, not form, will drive the level of duty a broker owes to the client.

\textbf{B. Investment Advisers}

Investment advisers are subject to the Investment Advisers Act of 1940 (the “Investment Advisers Act”). Courts have consistently held that investment advisers owe a heightened fiduciary duty to their customers, one that is greater than the duty that brokers managing non-discretionary accounts owe to their customers.\textsuperscript{24} This includes, for example, an obligation to monitor the performance of the account and recommend, and if authorized, make, appropriate changes to the customer’s portfolio.\textsuperscript{25}

The definition of “investment adviser” in the Investment Advisers Act does not include brokers whose performance of securities advisory services is solely incidental to the conduct of his business as a broker and who receives no special compensation therefore.\textsuperscript{26} However, some brokers offering certain types of accounts may be subject to regulation as investment advisers, and these brokers need to understand the different duties owed depending on the type of services that are rendered.\textsuperscript{27}

In 2005, the U.S. Securities and Exchange Commission (“SEC”) adopted a rule which exempted certain brokers from the Investment Advisers Act.\textsuperscript{28} The new rule applied to certain advisory, or fee-based, accounts and yet exempted brokers who do receive such special compensation as long as their advice is solely incidental to brokerage services and specific disclosure is made to the client.\textsuperscript{29} After adoption by the SEC, however, a federal court struck down the new SEC rule, finding that the SEC had overstepped its authority.\textsuperscript{30} In May 2007, the SEC decided not to appeal this decision, and instead asked the courts to allow investors and broker-dealers 120 days to make necessary changes to the affected account relationships.\textsuperscript{31} This series of events has created uncertainty about fee-based brokerage accounts, leading many brokerage firms to move away from these accounts so that they are not subject to the fiduciary duties of the Investment Advisers Act.\textsuperscript{32}

\textbf{C. Elder Abuse Statutes}

Because individuals ages 50 and above control at least seventy five percent of the nation’s household wealth and approximately forty percent of all elder abuse involved some form of financial exploitation, nearly every state has a statute directly or indirectly addressing the financial exploitation of elders.\textsuperscript{33} These statutes can be separated into three basic categories: (i) general application statutes, (ii) statutes specifically making unlawful financial abuse of the elderly and vulnerable, and (iii) statutes enhancing penalties for crimes against elderly and vulnerable victims.\textsuperscript{34} Importantly, some of these statutes may provide a basis for actions against broker-dealers and investment advisers.

\textbf{1. Statutes of general application}

Sixteen states\textsuperscript{35} and the District of Columbia do not have any criminal statute specifically addressing financial abuse of the elderly or vulnerable; instead, they utilize their state’s general theft statutes.\textsuperscript{36} “Since financial abuse involves a wrongful deprivation of the assets of another, much financial abuse could be classified as a form of theft.”\textsuperscript{37} As a result, general application criminal theft statutes can at least theoretically be used to prohibit financial abuse and to punish the abuse if it occurs.

\textsuperscript{22} Id.
\textsuperscript{25} Id. at 235-238.
\textsuperscript{29} Id.
\textsuperscript{30} Fin. Planning Ass’n v. SEC, 482 F.3d 481, 483 (D.C. Cir. 2007).
\textsuperscript{31} No S.E.C. Appeal of Court Ruling, WALL ST. J., May 15, 2007, at C18.
\textsuperscript{32} Id.
\textsuperscript{36} Dessin, supra note 34 at 289.
\textsuperscript{37} Id. at 288.
States using general applicability statutes, however, will likely encounter difficulty distinguishing between exploitation and the conduct traditionally considered as theft.38 “In the average theft prosecution, the prosecution does not need to even consider the possibility that the victim consented to the asset transfer. In the exploitation context, however, the question of whether the alleged victim consented should always be considered if the victim’s autonomy rights with respect to the disposition of his property are to be adequately taken into account.”39 General application statutes, as a result, will likely pose the least threat to broker-dealers and investment advisers.

2. Statutes specifically addressed to financial abuse of the elderly and vulnerable

Statutes specifically addressing financial abuse of the elderly and vulnerable can further be separated into three sub-categories: those that make unlawful financial abuse of both the elderly and the “vulnerable;” those that make unlawful only exploitation of only the elderly; and those that that make unlawful the financial exploitation of the “vulnerable.”40

In Florida, with its large population of seniors, the Adult Protective Services Act creates a private cause of action for so-called “vulnerable” persons.41 The statute provides that “a vulnerable adult who has been abused, neglected or exploited as specified in this chapter has a cause of action against any perpetrator and may recover actual and punitive damage for such abuse, neglect or exploitation.”42 With such an expansive definition of exploitation and a dearth of case law construing the statutory scheme, plaintiffs in Florida may successfully argue that the statute applies to broker-dealer or investment adviser abuses.43 In addition to this broad statute, Florida’s criminal law makes the exploitation of an elderly or disabled person illegal.44

Similarly, Georgia has a statute designed to protect the vulnerable and elderly. The Georgia statute’s purpose is to “assure the availability of protective services to all . . . elder persons in need of them.”45 Under the statute, exploitation of an elderly person is considered a misdemeanor.46 A recent amendment to the definition of exploitation could create potential liability for broker-dealers and investment advisers. “Exploitation” is now defined as “the illegal or improper use of a disabled adult or elder person or that person’s resources through undue influence, coercion, harassment, duress, deception, false representation, false pretense, or other similar means for another’s profit or advantage.”47

California’s statute, “Elder Abuse and Dependent Adult Civil Protection Act,” for example, protects both elders and dependent adults from financial abuse.48 The statute defines financial abuse to include any of the following acts:

“(1) takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both (2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.49

The statute provides civil remedies, including potential attorneys’ fees and pain and suffering damages, to any protected person who proves fiduciary abuse.50

3. Statutes enhancing penalties for crimes against the elderly and vulnerable victims

In contrast to the above two sub-categories, some states merely enhance criminal penalties for those convicted under general application statutes, where the victim is elderly.51 For instance, Arizona’s statute treats the victim’s status as a senior citizen (over 65) or a disabled person as an aggravating circumstance that enhances potential punishment for any underlying crime.52 Nevada provides additional penalties for crimes committed against individuals who are sixty-five or above.53 If the exploitation of a senior citizen was for an amount over $5,000, the perpetrator can be subject to a fine up to $10,000 or a prison term of two to ten years.54 In determining the appropriate punishment, the statute recommends combining “the monetary value of all of the money, assets and property of the older person or vulnerable person which have been obtained or used.”55

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38 Id.
39 Id.
40 Dessin, supra note 34 at 289.
42 Fla. Stat. § 415.111.
44 See Fla. Stat. § 825.103.
45 O.C.G.A. § 30-5-2.
46 O.C.G.A. § 30-5-8.
49 Passaro, supra note 43 at 81; see also Cal. Welf. & Inst. Code § 15610.30.
50 Cal. Welf. & Inst. Code § 15657; Dessin, supra note 34 at 386; Passaro, supra note 43 at 81.
51 Dessin, supra note 34 at 289.
54 Id.
III. REGULATORY CONCERNS ABOUT SALES PRACTICES AND THE SALE OF CERTAIN PRODUCTS TO SENIORS

Regulators are concerned that the industry is promoting sales of certain products to seniors, including mutual funds, variable products, equity-indexed annuities, and life settlement (vital) products, and further are concerned about certain sales practices that may be intended to exploit, or have the effect of exploiting, vulnerabilities of senior customers.

In a speech to the SIA Compliance and Legal Division in 2006, SEC Commissioner Annette Nazareth discussed a range of compliance issues, including fraud against senior citizens. Commissioner Nazareth noted that, “the [financial] industry is introducing increasingly complex products to the market . . . . some of these products have unusual features, or a combination of features, that are not well understood by [senior] investors’ such that firms’ must be especially vigilant in supervising brokers selling these products.”

Commissioner Nazareth went on to endorse the National Association of Securities Dealers, Inc.’s (“NASD”) April 2005 Notice to Members setting forth best practices for selling new products. In determining what constitutes a “new product” for compliance purposes, the Notice recommends asking the following questions:

- Is the firm proposing to sell a product to a different group of investors, for instance, retail? Will the product be offered by representatives who have not previously sold the product? Are there material changes to an existing product sold by the firm, raising increased risk to the customer, new fees or costs, or having different tax implications?

If the answer to any of these questions is yes, the product should be treated as new or materially different for compliance purposes, and the firm should: (i) determine whether to offer [the product] and to which investors, (ii) assess whether the product presents significant conflicts for the firm, and (iii) identify important features of the product that should be highlighted for sales and marketing staff and incorporated into appropriate training and supervision. Nonetheless, the rote application of this rubric, without more, would be insufficient to satisfy a firm’s obligations under Rule 3010 in the NASD’s view.

A. Variable Annuities

The sale or exchange of deferred variable annuities has become a perennial focus issue for regulators. The number of reported cases of purported unscrupulous sales tactics related to the sale of these products feeds the regulators’ concerns. Although these products have a variety of legitimate benefits, such as a death benefit and tax savings, these attributes are not necessarily needed or wanted by all senior investors.

As noted during the 2006 Seniors Summit hosted by the SEC, roughly 44% of all investor complaints about variable annuities products are made by seniors. The NASD and National Association of Insurance Commissioners (“NAIC”), as well as state regulatory organizations, have joined in an effort to educate the investing public, particularly seniors, about the sale and exchanges of these products. For example, in May 2006, the NASD held an Annuities Roundtable attended by state securities and insurance regulators and industry professionals. From the discussions held during the Roundtable, a working group was formed to consider various issues, such as “disclosure, suitability, supervision and marketing” of annuities.

During these meetings, regulators expressed concern about the perceived lack of oversight of the marketing and sale of variable annuities by securities firms and insurance companies. This concern has led to proposed legislation and new rules and regulations to force the securities and insurance industries to take more responsibility for monitoring and supervising the sale and exchanges of these products.

1. NASD proposed Rule 2821

   a. History of the proposed Rule

In December 2004, the NASD proposed Rule 2821 directed specifically to broker-dealer supervision and compliance regarding the sale and exchange of variable annuities. After reviewing pervasive comments about the undue burden, expense, and unreasonable time commitment that would be imposed on member firms and their supervisory personnel if the NASD adopted the proposed rule, the NASD proposed an amended Rule in 2006 and provided the industry a second opportunity to comment. Again, over 1,700 comments were received. In its 2006 Comment Letter, the NSCP expressed its main concerns with the

58 Id. at 7.
amended proposal, primarily the nature and timing of the required supervisory review, as well as the substantial cost and burden of developing and implementing systems and procedures to meet the express requirements of the amended proposal.60

To further explain and modify certain provisions of Proposed Rule 2821 in response to these comments, NASD filed with the SEC two additional amendments: Amendment No. 3 on November 15, 2006; and Amendment No. 4, which contains the full text of the revised proposed rule, on March 5, 2007. In its Release dated September 7, 2007, the SEC issued an order giving notice of Amendment Nos. 3 and 4 and approving the proposed rule as amended on an accelerated basis.61

A detailed recitation of all of the substantive comments sent to the SEC, the responses, modifications and clarifications made by the NASD in response thereto and the Commission’s findings, are beyond the scope of this paper.62 Nevertheless, we describe below the key changes made by the NASD in its latest set of amendments, and a summary of the key substantive provisions of the proposed rule in its current form.

b. NASD Amendment nos. 3 and 463

In Amendment No. 3, NASD modified the recommendation requirements in paragraph (b) of the proposed rule. Amendment No. 2 required members to have a reasonable basis to believe the customer has been informed of the material features of a deferred variable annuity. NASD revised the proposed rule to specify that a member must have a reasonable basis to believe that a customer has been informed “in general terms of the various features” of deferred variable annuities. NASD made this change in response to comments to clarify that the customer need only be informed about the features of deferred variable annuities in general terms, rather than be informed about the specific features of the deferred variable annuity the member might recommend. In addition, in Amendment No. 3, NASD incorporated the factors that a firm must consider when exchanging deferred variable annuities in the recommendation requirements rather than in the principal review and approval requirements, while maintaining a requirement that principals consider these factors. NASD also eliminated two of the considerations relating to exchanges in response to comments: the extent to which the customer would benefit from the unique features of a deferred variable annuity and the extent to which the customer’s age or liquidity needs make the investment inappropriate.

Moreover, in Amendment No. 3, NASD revised the proposed rule in response to comments relating to the applicability of the proposed rule to non-recommended transactions. NASD clarified that while principals are to treat all transactions as recommended, a principal may authorize the processing of a transaction if it determines that the transaction was not recommended and that the customer affirms that he or she wants to proceed after being informed of the reason why the registered principal has not approved the transaction.

In Amendment No. 3, NASD also modified the supervisory procedures provisions of the rule in response to comments that the term “particularly high rates of effecting deferred variable annuity exchanges” was vague. NASD revised the proposed rule to require implementation of surveillance procedures to review associated persons’ rates of effecting deferred variable annuity exchanges for consistency with the proposed rule, other NASD rules and the federal securities laws. NASD also clarified that members must have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges.

In addition, in Amendment No. 3, NASD revised the required timeframe for principal review, which it further revised in Amendment No. 4. As amended by Amendment No. 4, the principal must review the application prior to transmitting it to the issuing insurance company for processing, but no later than seven business days after the customer signs the application. This “prior to transmittal” standard was also incorporated in Amendment No. 1, and the Commission received a substantial number of comments on this standard. Although Amendment No. 1 did not explicitly limit the timeframe for principal review to no more than seven days, provisions of Exchange Act Rule 15c3-3 would have operated to limit the time in which broker-dealers could hold customer funds. In light of NASD’s requested exemption from Rule 15c3-3, the seven-day limit on principal review in Amendment No. 4 would replace that rule’s time limitation for transactions subject to that exemption with a more workable limit.

c. Proposed Rule 2821 in its current form64

Proposed Rule 2821 would create recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. According to the SEC, it is intended to supplement, not replace, NASD’s other rules relating to suitability, supervisory review, supervisory procedures and training.

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62 For such discussion, see Exchange Act Release No. 34-56375, supra note 61.

63 Id. at pp. 41-42.

64 Id. at pp. 2-8.
Proposed Rule 2821 would apply to the purchase or exchange of a deferred variable annuity and to an investor’s initial subaccount allocations. It would not cover customer sales of deferred variable annuities, including the sale of a deferred variable annuity in connection with the replacement of a deferred variable annuity with another product. Nevertheless, the NASD’s general suitability rule, Rule 2310, and other relevant general rules, would still apply.

The proposed rule also generally would not apply to an investor’s purchase or exchange of a deferred variable annuity in a tax-qualified, employer-sponsored retirement or benefit plan, except if an NASD member firm recommends a deferred variable annuity to an individual plan participant.

Proposed Rule 2821 has four main requirements. First, in order to recommend the purchase or exchange of a deferred variable annuity to an individual plan participant.

• The customer has been informed, in general terms, of various features of deferred variable annuities;
• The customer would benefit from certain features of deferred variable annuities, such as tax deferred growth, annuitization, or a death or living benefit; and
• The particular deferred variable annuity that the member is recommending, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and the riders and similar product enhancements are suitable (and in the case of an exchange, the transaction as a whole also is suitable) for the customer based on the information the person associated with the member is required to make a reasonable effort to obtain pursuant to subparagraph (b)(2) of the proposed rule.

Prior to recommending that a customer exchange a deferred variable annuity, a registered representative must not only have a reasonable basis to believe that the exchange is consistent with the suitability determinations in subparagraph (b)(1)(A) of the proposed rule, but must also consider whether:

1. The customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, or be subject to increased fees or charges;
2. The customer would benefit from product enhancements and improvements;
3. The customer’s account has had another deferred variable annuity exchange within the preceding 36 months.
4. The associated person recommending the transaction would be required to document these considerations and sign this documentation. She would also have to make reasonable efforts to obtain from the customer information regarding the customer’s age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

Second, a registered principal would have to review the transaction and determine whether she approves of it prior to transmitting the customer’s application to the issuing insurance company for processing, but no later than seven business days after the customer signs the application. The registered principal may approve the transaction only if she has determined that there is a reasonable basis to believe that the transaction would be suitable based on all of the factors contained in paragraph (b) of the proposed rule.

65 NASD’s general suitability rule, Rule 2310, would continue to apply to reallocations of subaccounts.
67 See Proposed Rule 2821(b)(1)(A)(ii). The proposed rule lists the following features as examples for purposes of this requirement: (1) potential surrender period and surrender charge; (2) potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; (3) mortality and expense fees; (4) investment advisory fees; (5) potential charges for and features of riders; (6) the insurance and investment components of deferred variable annuities; and (7) market risk.
73 See Proposed Rule 2821(b)(2).
74 See Proposed Rule 2821(c). NASD determined that relief is needed to allow certain broker-dealers to complete their review of deferred variable annuity transactions as required by proposed NASD Rule 2821 without becoming fully subject to Exchange Act Rule 15c3-3 and being required to maintain higher levels of net capital in accordance with Exchange Act Rule 15c3-1. Consequently, NASD has requested relief from Rules 15c3-3 and 15c3-1 for these broker-dealers. In conjunction with the Commission’s approval of proposed rule 2821, it also grants exemptions from Rules 15c3-1 and 15c3-3 of the Exchange Act to allow NASD members to comply with proposed Rule 2821 without becoming fully subject to Exchange Act Rule 15c3-3 and being required to maintain higher levels of net capital in accordance with Rule 15c3-1.
75 See Proposed Rule 2821(c).
For purposes of reviewing deferred variable annuity purchases and exchanges, a registered principal must treat all transactions as if they have been recommended. However, if a registered principal determines that a transaction, which is not suitable based on the factors contained in paragraph (b), was not recommended, she may nonetheless authorize the processing of it if the customer has been informed of the reason why the transaction has not been approved and the customer affirms that she wants to proceed with the transaction.

The registered principal who reviews the transaction must document and sign the determinations that the proposed rule requires her to make. She must complete this documentation regardless of whether she approves, rejects, or authorizes the transaction.

Third, Proposed Rule 2821 would require members to develop and maintain supervisory procedures that are reasonably designed to achieve compliance with the proposed rule. Members would be required to implement surveillance procedures to determine if associated persons “have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of [the rule], other applicable NASD rules, or the federal securities laws (‘inappropriate exchanges’).” Members would also be required to have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

Fourth, Proposed Rule 2821 would require members to develop and implement training programs that are tailored to educate registered representatives and registered principals on the material features of deferred variable annuities and the requirements of the proposed rule.

The staid tenor of this new proposed suitability rule and the unprecedented adoption of such a specialized supervisory rule exemplify the heightened concern of the regulators regarding sales of variable products to seniors and highlight the increased risks and potential exposure to investment professionals in recommending the sale or exchange of these products to seniors.

2. Model rules regulating insurance companies

The securities industry is not the only industry under close scrutiny. The insurance side of annuities sales and exchanges is also at the forefront of the regulators’ minds.

In 2000, the NAIC published a White Paper expressing concern over the sale of life insurance and annuity products by insurance companies, and recommended certain supervisory standards. This White Paper led to the adoption in 2003 of the “Senior Protection in Annuity Transactions Model Regulation.” This Model Rule was revised in 2006 to include sales of annuities to all investors. As of October 2006, twelve states have adopted the broader model regulation, two states have proposed adopting that regulation, nine states have adopted the regulation related to seniors, and six other states have separate suitability standards related to annuity sales by insurance companies not related to the NAIC model regulation.

Generally, these state insurance rules obligate insurance companies doing business in those states to develop reasonable systems to monitor the sale and exchange of variable annuities, whether the company has a captive or independent sales force. Most state regulations require insurers to maintain written standards of suitability. In some instances, states require insurers to verify that firms are performing suitability supervision of the registered representatives selling variable annuities to the investing public.

In sum, deferred variable annuity sales have likely been and will continue to be a focus of concern for regulators for some time, necessitating caution by compliance professionals related to the sale and exchange of these products.

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76 Id.
77 Id.
78 Id.
79 Id.
80 See proposed Rule 2821(d).
81 Id.
82 Id.
83 See Proposed Rule 2821(c).
85 Id.
86 Id.
87 A “captive” agent is one that is licenses to sell insurance exclusively for one company.
88 Jorden, supra note 84 at *57.
B. Life Settlements

1. Background

“Viatical settlement” or “life settlement” describes a transaction where an investor buys life insurance policies from policy owners, makes premium payments as they come due, and then collects death benefits when the insured persons die. The viatios (insured persons) usually have shortened life expectancies. Obviously then, because of their age, seniors have become targets of the industry.89

A viator transfers his beneficiaries’ interests in the subject life insurance policy to another person or company as consideration for an immediate cash payment of a portion of the face amount of the policy which would be due upon the viator’s death.90 Once the purchaser pays the viator the agreed upon amount, the purchaser becomes obligated to continue the premium payments until the viator dies in order to keep the policy in force.91 When the viator dies, the policy matures and the purchaser then receives the face amount of the policy.92 Therefore, with a life settlement, “an investor ordinarily will realize a return of their principal as well as an additional return as part of the investor’s share of the face amount of the policy.”93

Life settlements are often referred to as “senior settlements” because most life insurance policies bought in the industry today insure the lives of senior citizens. According to Sanford C. Bernstein & Co., in 2005, the industry had sales totaling $10 billion, and it is said this number rose to $15 billion in 2006 and could double to $30 billion in 2007.94

2. Problems in the industry

Many companies and brokers selling senior settlements are not licensed. The commissions paid by senior settlement companies to senior settlement brokers and other financial professionals can be as high as 30%. This can lead to deceptive practices by such brokers. Indeed, the industry has been plagued historically by significant sales practice abuses, both on the buy side, i.e., the viator selling the policy, and on the sell side, i.e., sales to investors without proper risk disclosure.

Buyers are guaranteed a rate of return, but the trigger event is the death of someone else. Thus, the longer the viator lives, the more the return diminishes, making it less likely that any guaranteed return can be achieved.95

There are also privacy concerns, as the policy seller usually signs a release authorizing the disclosure of the insured’s medical and other personal information. Sometimes, the seller also must provide periodic updates about the health of the insured to the buyer. Once the buyer obtains this information, it may be shared with other parties, including lenders or third party investors.

3. Model regulations and NASD Notice to Members 06-38

To address these and other issues, in 1993, the NAIC created and adopted the Viatical Settlements Model Act (the “Model Act”). Revisions have been made to include life settlements and “senior settlements.” The Model Act mandates licensing for providers and brokers, as well as licensee annual reporting requirements, includes language governing advertising, and provides protections against disclosure of the insured’s identity or medical information. It requires disclosure to the purchaser of (1) options available, other than the purchase of a life settlement, (2) proceeds that are taxable in the transaction, and (3) methods for calculating the broker’s compensation. The Model Act also requires the viator to deposit the executed documents with an independent escrow agent.

Most states have adopted the Model Act, but several jurisdictions, including Alabama, Hawaii, Idaho, Missouri, Rhode Island, South Carolina, West Virginia, and Wyoming, still have not adopted the act or a statute similar in nature. New Hampshire has appointed a committee to study the implementation of the Model Act. Guam, Puerto Rico, and the Virgin Islands also have not adopted a statute regulating life settlements. In these jurisdictions, the primary consideration for any relief under the law is whether the life settlement can be considered a security and can thereby be regulated by a state’s securities laws.

Courts, however, are in disagreement as to whether viatical settlements are “securities” as contemplated by the Securities Acts of 1933 and 1934. Most notable for their disagreement are the D.C. Circuit in SEC v. Life Partners, Inc.96 and the Eleventh Circuit in SEC v. Mutual Benefits Corp.97 The D.C. Circuit held that viaticals are not securities while the Eleventh Circuit held that they were.

90 See id.
91 See id.
92 See id.
93 See id.
95 See 2006 Seniors Summit, supra note 2 at 49 (comments of Anthony Lewis, California Dept. of Corporations).
97 S.E.C. v. Mutual Benefits Corp., 408 F.3d 737 (11th Cir. 2005).
This disparity arises from ambiguities in the definition of the term “security.” Both the Securities Act of 1933 and the Securities and Exchange Act of 1934 define “security” to include “investment contracts.” 98 Neither Act, however, defines “investment contracts.” 99 As a result, courts apply the Howey test, announced by Supreme Court in 1946, 100 to determining whether a particular transaction qualifies as an “investment contract.”

The difference between the holdings by the D.C. and Eleventh Circuits results from their differing interpretations of the third-prong of the Howey test – that investors’ expectations of profits be based solely on the efforts of the promoter or a third party. 101 The Life Partners majority concluded that because “the length of the insured’s life . . . is of overwhelming importance to the value of viatical settlements[,] the SEC is unable to show that the promoter’s efforts have a predominant influence upon investors’ profits.” 102 Over the dissent of Circuit Judge Wald, the majority distinguished efforts by the promoter occurring prior to and after the sale of the purchase of the viatical settlement. The majority asserted its doubt “that pre-purchase services should ever count for much.” 103 Thus, because the third prong was held to be unsatisfied, the court ruled viaticals were not securities.

In contrast, the Mutual Benefits court saw “no basis for excluding pre-purchase managerial activities from the analysis.” 104 The Eleventh Circuit interpreted Howey as necessitating a broad, flexible application of the Securities Acts “to all schemes devised by those who seek the use of money of others on the promise of profits.” 105 Stating that “there is no basis for excluding pre-purchase managerial activities from the analysis,” the Eleventh Circuit concluded that the purchase of viatical settlements was a “classic investment contract[ ] . . . . under the Securities Acts of 1933 and 1934.”

Presently, courts are likely to consider viatical settlements to be securities where the efforts of the promoter – both pre- and post-purchase – significantly influence investors’ profits. Even the D.C. Circuit has stated as much. Upon denying the SEC petition for rehearing, Circuit Judge Ginsburg made clear that the D.C. Circuit considers both pre- and post-purchase efforts to be relevant, but that the SEC failed to identify any such effort in S.E.C. v. Life Partners, Inc. 106

Importantly, in an August 2006 Notice to Members, the NASD reminded firms that life settlements involving variable insurance policies are securities and are subject to applicable NASD rules. 107 The NASD also requires its members to meet the best execution obligations of NASD Rule 2320, i.e., “to use reasonable diligence first to ascertain the best market for the security, and then to obtain the most favorable price possible in that market under prevailing market conditions.” 108

C. Equity-indexed Annuities

1. Background

Equity-Indexed Annuities (“EIA”) share characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. EIAs also have greater risk (but more potential return) than a fixed annuity but less risk (and less potential return) than a variable annuity. 109 EIAs offer a minimum guaranteed interest rate combined but less risk (and less potential return) than a variable annuity. 110

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Significantly, heretofore most EIAs have not been registered as “securities,” and consequently, regulatory oversight of the

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99 Id.
100 See S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (“[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . .”).
101 Id.
102 Life Partners, 87 F.3d at 548.
103 Id. at 548. Months later, the D.C. Circuit denied the SEC’s petition for rehearing. In a statement attached to the Order, Circuit Judge Ginsburg stated that the Court examined both the pre-purchase and post-purchase efforts by the promoter and “concluded that the two in combination were not enough.” S.E.C. v. Life Partners, Inc., 102 F.3d 587, 588 (D.C. Cir. 1996). Judge Ginsburg stated, “[n]othing in our application of the Howey test can reasonably be construed to suggest that pre-purchase efforts are ‘irrelevant.’” Id.
104 Mutual Benefits., 408 F.3d at 743.
105 Id. at 743, 745.
108 Id. at 4.
110 See id.
marketing and sale of EIAs has been limited. Not surprisingly, these circumstances have resulted in this product being sold widely to elderly and unsophisticated customers. A recent survey found that “[i]n California, 75 percent of the state’s senior investment fraud cases involve unregistered securities. Cases involving variable or equity-indexed annuities constituted 65 percent of the caseload in Massachusetts, and 60 percent in both Hawaii and Mississippi.”

2. Are EIAs securities?

The SEC asserts that EIAs may be securities, depending on their mix of features, but has recognized a need to regulate this type of investment. In 1997, the SEC issued a Concept Release requesting comment on the then new EIA industry. On April 10, 2007, the SEC warned investors considering buying EIAs that they “should fully understand how an equity-indexed annuity computes its index-linked interest rate before buying.” Furthermore, it warned that the typical equity-indexed annuity is not registered with the SEC.

The NASD has also issued warnings recognizing the dangers of the EIA industry. In August 2005, the NASD issued a Notice to Members regarding supervision of unregistered EIAs by registered representatives. The notice describes potentially misleading marketing claims used by sellers of EIAs and encouraged broker-dealers to adopt enhanced supervisory procedures for the sale of EIAs by their registered representatives. The NASD also warned of the complexity of EIAs and the difficulty faced by a broker in determining whether an EIA is suitable for a buyer. The NASD also recognized EIAs’ close relationship to securities: “[t]he question of whether a particular EIA is an insurance product or a security is complicated and depends upon the particular facts and circumstances concerning the instrument offered or sold.”

Separately, firms shall at the least consider the sale of unregistered EIAs by associated persons in their capacity as insurance agents as an outside business activity subject to NASD Rule 3030. Of course, under Rule 3030, firms are not required to supervise outside business activity as they would securities transactions.

3. State regulation

The five states with the highest senior population (Florida, Pennsylvania, New York, California, Texas) also recognize the dangers of EIAs and are taking significant steps toward regulation. In general, like the SEC and NASD, the five states recognize the complexity of EIA products and are making a considerable effort to ensure that consumers purchasing them are informed about what they are buying and how they work. For example, Florida, Pennsylvania, New York, and Texas have specific provisions concerning what must be disclosed to the buyer at the time of purchase and what information about the EIA must be included in purchasing forms. These states also require:

1. a description of how the equity-indexed values are to be determined and calculated;
2. disclosure of the equity index to be used;
3. a description of the floors and caps applicable to index increases;
4. descriptions of what benefits will not be provided in the annuity; and
5. disclosure of the minimum nonforfeiture amounts in the contract to be included in each one of the state’s EIA contracts.

Furthermore, those states, except California, which has pending legislation in conformity with the other four states, have brought the EIAs under their respective state insurance regulations. Moreover, Florida, New York, Texas, and California in its pending legislation, have regulations that control the minimum nonforfeiture amount.

The regulations of these five states mark a significant step towards completely regulating the EIA industry. These states have enabled investors to make more informed decisions through disclosure requirements, state-approved forms, and guidelines for the formulas utilized in EIA products.

D. Advertising and Marketing

Compliance professionals must be vigilant in monitoring the content of marketing materials bearing their firm’s imprimatur. NASD Rule 3010 requires that members “establish and maintain a system to supervise the activities [of their employees] that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.”

111 2006 Seniors Summit, supra note 2, at 15.
114 Id. at 3.
115 Id.’s note 2.
investors. Rule 2210 states “[n]o member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.”116 In light of the obligations and strictures of these two rules, compliance professionals must walk a fine line between ensuring compliance with applicable laws and regulations and avoiding the stifling of legitimate marketing activities of their firms.

1. Free lunch sales seminars

While free lunch sales seminars have long served as a legitimate marketing tool, the SEC recently has expressed renewed concern that a growing number of these seminars are targeting senior citizens, often employing high-pressure sales tactics to persuade seniors to purchase inappropriate or overly risky financial products. The seminars have titles like “Senior Financial Survival Seminar” and “Senior Financial Safety Workshop” and advertise a suite of services, including investment advice, estate planning, retirement planning and inheritance advice.117

The proliferation of these marketing efforts has been remarkable. According to the SEC, “78 percent of seniors received a free lunch seminar invitation and 60 percent received six or more invitations in the past three years.”118

Research suggests that seniors are more likely to attend these seminars because they are held at local hotels and restaurants, environments in which seniors are more comfortable as compared to downtown office buildings.119 The seminars are often hosted by a single individual, not a national financial firm. Studies have shown that seniors readily develop relationships with these individuals, who they perceive to be reliable and trustworthy.120

In March 2006, SEC Chairman Christopher Cox announced that the SEC was teaming up with the NASD, NYSE and state regulators to investigate these seminars.121 The investigation targeted seminars in the Sun Belt, the southernmost region of the country stretching from the Carolinas to southern California, because these states have become popular retirement destinations for aging baby-boomers.122 On September 10, 2007, during the SEC’s 2007 Seniors Summit, the SEC, the North American Securities Administration Association (“NASAA”) and the Financial Industry Regulatory Authority (“FINRA”) released their joint report summarizing the results of their examinations of free lunch investment seminars entitled: Protecting Senior Investors; Report of Examinations of Securities Firms Providing “Free Lunch” Sales Seminars, September 2007, available at www.finra.org/reports.

The results of these examinations confirm that there is no such thing as a “free lunch.” Indeed, contrary to sponsors’ characterizations of these events as “workshops” or “educational sessions” at which “nothing will be sold”, these seminars invariably amounted to nothing more than sales presentations designed to induce attendees to open new accounts and purchase investment products.123 Significantly, regulators found that 59 percent of these seminars reflected inadequate supervisory practices, which in turn contributed to their finding that 50 percent of seminars featured exaggerated or misleading advertising claims, and 23 percent involved possibly unsuitable recommendations.124

In the course of the coordinated examinations, regulators further found a variety of troubling sales practices, including the use of false or misleading sales materials used in connection with high-pressure sales seminars aimed exclusively or primarily at seniors or those at or nearing retirement. Among the most common practices were inaccurate or exaggerated claims regarding the safety, liquidity or expected returns of the investment or strategy being touted; scare tactics; misrepresentations or material omissions about the product or strategy; conflicts of interest; or misleading credentials used by persons sponsoring or participating in the seminar. The examinations also detected instances in which advertisements failed to include the firm’s name, or made improper use of testimonials, in violation of NASD Rule 2210(d).125

2. Senior specialists

What is in a name? For some, it is a means to develop trust where that trust is not warranted. “Certified Financial Gerontologist,” “Certified Wealth Preservation Planner,” “Retirement Income Specialist,” and “Senior Specialist” are a few of the many designations financial advisers use to signify expertise in senior-specific financial issues. While some of these

117 2006 Seniors Summit, supra note 2, at 54.
119 2006 Seniors Summit, supra note 2 at 56.
120 Id.
122 2006 Seniors Summit, supra note 2 at 54-55.
123 Id.
124 Id.
designations may be attained only after completing extensive course work and logging a specified number of hours of in-the-field experience, according to NASAA “a number of entities formed in the last few years have created designations with much less stringent requirements,” and “the training they receive is often nothing more than marketing and selling techniques targeting the elderly.” For example, NASAA has noted that a number of entities formed to sell EIAs have lax requirements for their associates to receive the title “senior specialist.” NASAA brought twenty-six cases in 2005 alone involving senior specialists’ securities recommendations.

These “specialists” often advertise in local newspapers and via direct mailings targeting seniors. They may offer to come to seniors’ homes for private consultations, or they may invite seniors to attend a free seminar held at a local restaurant or hotel. One sector of the economy that has attracted a disproportionate number of such “senior specialists” is the insurance industry, where the need for additional sales representatives has led some companies to overlook potentially suspect “senior specialist” credentials. Regardless, the advice from these specialists is often the same – after reviewing a senior’s assets, the specialist recommends the liquidation of all securities and the reinvestment of the proceeds in indexed or variable annuity products offered by the specialist.

FINRA recently expressed its concern about the proliferation of professional designations, particularly those that suggest an expertise in advising seniors, in its September 2007 Notice to Members entitled “Senior Investors.” In this Notice to Members, FINRA noted that firms that allow the use of any title or designation that conveys an expertise in senior investments or retirement planning where such expertise does not exist may violate NASD Rules 2110 and 2210, NYSE Rule 472, and possibly the anti-fraud provisions of the federal securities laws. FINRA further noted that some states prohibit or restrict the use of senior designations.

3. Other examples of misleading advertising and marketing materials

Free lunch seminars and individuals purporting to be senior specialists are not the only questionable marketing practices targeting seniors. Similar to the “senior specialist” designation, the National Ethics Bureau’s “Seal of Trust” has been used by unscrupulous salesmen to gain, and subsequently abuse, the confidence of senior investors. While the National Ethics Bureau portrays itself as a public service organization established to certify the ethical caliber of its members, in reality the Bureau is a for-profit corporation, and all one must do to obtain its Seal of Trust is fill out a simple online application and pay a registration fee. For example, in 2006, the Bureau awarded its Seal to an individual who (i) had been the subject of an NASD arbitration proceeding for churning stock; (ii) was subject to claims for damages in excess of $70,000 in connection with unsuitable purchases and misrepresentations of over-the-counter stocks; (iii) had tax liens against him for $30,000; (iv) was involved in a Chapter 11 bankruptcy of a business partnership; and (v) was the focus of a customer complaint regarding unauthorized trading.

Another advertising scheme theme that relies on imprimatur of authority and trustworthiness involves marketing materials created by third-party publishing companies. These companies provide agents with “pre-written books, articles and newsletters which are used to give prospective clients the impression that an agent has specialized expertise that he or she does not really have.” While the proliferation of the Internet and alternative media have forced Generation X to learn that you cannot always believe what you read, Baby Boomers are more likely to find persuasive materials which, at least superficially, appear to be “official” publications.

127 See id.
128 See id.
130 NASAA Press Release, supra note 95.
131 FINRA NTM 07-43, supra note 124 at p. 5.
132 For example, Nebraska prohibits the use of senior designations, while Massachusetts permits the use of designations only if they have been approved by an independent accreditation agency. See Interpretative Opinion No. 26: Use of Certifications and Designations in Advertising by Investment Adviser Representatives and Broker-Dealer Agents, Special Notice of the Nebraska Department of Banking and Finance (November 13, 2006), available at www.ndbg.org/forms/bd-ia-special-notice.pdf. The Massachusetts regulations became effective June 1, 2007. See 950 Mass. Code Regs. 12-204(2)(j)(2007) (Registration of Broker-Dealer Agents, Investment Adviser, Investment Adviser Representatives and Notice Filing Procedures), and the Notice of final Regulations, available at www.sec.state.ma.us/sci/scipropreg/propreg.htm. Further, as of the date of this Notice, the North American Securities Administrators Association, Inc. (NASAA) was developing a model rule that would “mak[e] it a separate violation of law to use designation or certification to mislead investors. Once the model rule has been released for public comment and ultimately approved by the NASAA membership, [NASAA] will urge its adoption in every jurisdiction.” Testimony of Joseph P. Borg, Director, Alabama Securities Commission and NASAA President, Before the Special Committee on Aging, United States Senate (September 5, 2007).
133 Testimony of William Francis Galvin, Secretary of State, Commonwealth of Massachusetts, Before the Special Committee on Aging, United States Senate (September 5, 2007).
134 Id.
135 Id.
The “Piece of Pie” sales model (“PPSM”) is an altogether different marketing scheme targeting senior investors. The PPSM is designed to isolate seniors from their preexisting financial advisors so that the salesperson may market unnecessary and/or unsuitable products without interference from objective, disinterested third parties. In an effort to gain seniors’ trust and alleviate any initial concerns they may have regarding investment schemes, PPSM salespeople are trained to wait until the third or fourth meeting before pitching their investment products. As an example of the tactics this program will employ, PPSM salespeople have been known to make presentations suggesting that “banks may not be safe, that the average rate of return in the stock market is ‘a big lie’, that the idea that stocks protect you from inflation ‘is a myth’ and that stock brokers will gamble ‘your money ... not just their own.’” Moreover, these salespeople will play on seniors’ other, unrelated fears – such as bird flu and identity theft – to convince seniors to invest in their products.

Finally, the dissemination of marketing materials to seniors with exaggerated returns and “get rich quick” promises continues in earnest. For example, in August 2006, the SEC brought an action to halt an “early retirement” investment scheme that had raised more than $20 million by promising to help investors retire “in just seven short years” by investing their IRA funds ‘to take advantage of the booming real estate market’ and ‘to produce double-digit returns.” The defendants relied on direct mailings to advertise seminars with titles like, “Retirement Secrets of the Rich: What your Accountant and Stockbroker don’t want you to know.” According to the SEC, in violation of NASD regulations, these mailings promised unreasonable and exaggerated returns without mention of any corresponding risk.

On September 14, 2006, the NASD charged broker David McFadden with securities fraud based on his purported practice of promising “unreasonable and exaggerated” returns to potential investors. Specifically, the NASD noted that McFadden had presented a series of seminars suggesting that the long-term employees of a certain corporation could retire early if they would liquidate their company-sponsored 401(k) plans and pension plans and invest in products recommended by Fadden. The NASD stated that:

McFadden’s seminar materials included a slide showing projections of account values over 20 years with rates of return ranging from 5 percent to 18 percent – for a hypothetical customer having retirement savings of $600,000 who made annual withdrawals starting at $58,000 per year (9.67 percent of the initial balance) after one year. Withdrawals were also shown as increasing by $6,000 every five years. The slide depicted the investment as compounding steadily over time and included no explanation that investments offering the potential for higher rates of return also involve a higher degree of risk to principal.

E. Point of Sale Disclosures

As discussed earlier, in both discretionary and non-discretionary accounts, broker-dealers have an obligation at the time of the transaction to provide their clients with information about recommended investments, including information about the risks of the investment, the broker’s commission, and the broker’s claimed possession of inside information. This disclosure of material information pertinent to the client’s decision whether to invest at the time of that decision is often referred to as a point of sale disclosure.

Recognizing that broker-dealers were not always adequately disclosing information to their clients at the point of sale, the SEC has proposed, and requested comment on, two new rules to regulate disclosures at the point of sale: 15c2-2 and 15c2-3. These rules would require broker-dealers to provide their customers with information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares, 529 college savings plan interests, and variable insurance products.
In January 2004, the SEC first “issued, and requested comment on, two proposed new rules . . . and rule amendments under the Securities Exchange Act of 1934 designed to enhance the information broker-dealers provide to their customer in connection with transactions in certain types of securities.”\textsuperscript{147} Since proposing the new rules, the SEC has recognized “a number of areas that could be enhanced to make the proposed rule [15c2-3] more effective” with regard to point of sale disclosures. These areas relate to: (i) the content and format of proposed disclosure; (ii) oral disclosures; (iii) the timing of disclosure; (iv) exceptions to the requirements; and (v) special issues for variable products.\textsuperscript{148}

\textbf{a. Content and format}

The SEC received “substantial feedback on the point of sale forms that would be required under proposed rule 15c2-3.”\textsuperscript{149} Areas of investor concern included: confusion over use of “industry jargon”; unhelpfulness of definitions and explanatory materials; inadequacy of forms with regard to differentiation between one-time costs and ongoing costs; and lack of comprehensive information about all costs (rather than just distribution-related costs).\textsuperscript{150}

In response to suggestions about the forms, the SEC developed revised forms which “[b]roker-dealers would be required to deliver . . . at the point of sale before a customer purchases a covered security.”\textsuperscript{151} In an effort to avoid “information overload,” the revised forms would abandon the “one size fits all” format and disclose only specific categories of information in a required format. Categories of information that are not applicable to a particular purchase would be omitted.\textsuperscript{152}

The SEC noted several desirable attributes of its revised point of sale disclosure forms:

1. Clarity (clearer and easier to understand);
2. Identification of the security subject to disclosure (broker-dealers required to more clearly identify the security subject to disclosure);
3. Combined use of standardized and transaction-specific cost disclosure (if customer requests, broker-dealers would be required to disclose cost information reflecting customer’s anticipated payment amount);
4. Presentation of sales fee disclosure (sales fees in dollars and as percentage of amount invested, back-end sales fees as a “maximum”, breakpoint (or “volume”) discounts);
5. Comprehensive annual cost disclosure (all costs of owning the securities, including investment company costs such as “management fees” and “other expenses,” in both dollars and percentage of amount invested);
6. Disclosures tailored to share class and pricing structure; and
7. Disclosure of all share classes under consideration.\textsuperscript{153}

\textbf{b. Oral disclosure of point of sale information}

Some commenters questioned whether oral disclosures would ever be appropriate “in light of difficulties associated with monitoring compliance and the need to give investors the opportunity to consider the point of sale information when making investment decisions.”\textsuperscript{154} In place of oral disclosures, some commenters suggested the use of Internet-based alternatives or after-the-fact disclosure.\textsuperscript{155} Other commenters claimed that verbatim reading of the point of sale form was impractical, and suggested that customers be able to opt out of disclosure in certain situations.\textsuperscript{156} With regard to Internet-based disclosure and after-the-fact disclosure, the SEC stated its concern that such disclosure would be “ineffective at providing investors with key information about costs and conflicts contemporaneous with investment decisions . . . .”

Although the SEC has recognized the concern of securities industry professionals regarding the effectiveness of oral disclosures, the Commission has shied away from the use of Internet-based alternatives as a replacement. Electing instead to focus on making oral disclosures more effective, the SEC continues to contemplate how to increase the usefulness of oral disclosures to the investor, while simultaneously lessening the burden placed on brokerage firms.

\textsuperscript{147} Id. at 3.
\textsuperscript{148} Id.
\textsuperscript{149} Id. at 3-4.
\textsuperscript{150} Id. at 4.
\textsuperscript{151} Id.
\textsuperscript{152} Id.
\textsuperscript{153} Id. at 5-6.
\textsuperscript{154} Id. at 15.
\textsuperscript{155} Id.
\textsuperscript{156} Id.
c. Timing of point of sale disclosure

The proposed rule would have required disclosure “immediately prior” to acceptance of an order. Some commenters suggested “adding a time-of-recommendation component to trigger the disclosure,” while others suggested that “point of sale disclosure could be provided most efficiently at the time of account opening.” Many commenters suggested that “investors should receive disclosure earlier in the sales process to have adequate time to consider the information when making investment decisions.” The SEC has stated its desire that “investors should receive information early enough . . . to give them adequate time to consider the information, but not so early that they receive multiple disclosures for securities they may not be interested in purchasing.” There is no consensus on the issue.

d. Exceptions to point of sale disclosure requirements

Commenters generally encouraged the SEC to provide the following exceptions to the proposed requirements point of sale disclosure requirements:

- For an investor’s non-periodic purchase of a covered security following his or her initial purchase;
- For subsequent purchases of a covered security . . . to reduce disclosures that would otherwise be redundant;
- For purchases by institutional investors and for transactions in which the broker-dealer exercises investment discretion.

The SEC considered these suggestions and requested further comment on whether a subsequent purchase exception would appropriately balance the goals of enhancing investment decision making and reducing potentially duplicative disclosures.

e. Special issues for variable products

The SEC recognized that its proposed point of sale forms were not well suited for illustrating costs associated with variable insurance products. The SEC also noted comments by industry professionals suggesting that the proposed point of sale forms were not reflective of each product’s particular terminology, features, and pricing structure.

The SEC currently is evaluating the suggestions of securities industry professionals regarding the possibility of adopting written point of sale disclosure requirements for variable annuities and variable life insurance products. Specifically, the SEC is considering whether the implementation of such requirements would enhance investor understanding of those products, and whether such requirements would better ensure appropriate disclosure of the costs and conflicts associated with variable life insurance products.

2. The NASD Mutual Fund Task Force

In 2005, the NASD Mutual Fund Task Force recommended a streamlined, interactive approach to point of sale disclosure requirements. The Task Force trumpeted what it called the “Profile Plus,” suggesting that a brokerage firm provide on its website a document outlining, in easy-to-understand language, relevant and important features of an investment. This document, called the “Profile Plus,” would also contain hyperlinks to more detailed information about the investment. To satisfy the point of sale disclosure requirement, a broker-dealer would be required to provide the Profile Plus on its website and refer investors to the disclosure “unless an investor opts out of this form of delivery.”

a. Point of sale disclosure through the Profile Plus

The Task Force recommended that the SEC adopt the following measures in order to improve mutual fund disclosure:

157 Id. at 18.
158 Id.
159 Id.
160 Id.
161 Id.
162 Id. at 19.
163 Id.
164 Id. at 20-21.
165 Id. at 22.
166 Id.
168 Id.
• Mandate delivery by broker-dealers of a Profile Plus document, to ensure that simple, clear disclosure reaches the retail investor. The inclusion in the Profile Plus of hyperlinks to the full fund prospectus also should alleviate liability concerns.

• Disclosure on broker-dealer websites, with broker-dealers referring investors to this disclosure, generally should be the mode of delivery mandated by the Commission.169

Observing that “[m]ost investors today have ready access to the Internet,” the Task Force suggested that “[w]eb site disclosure would, for most investors, be the simplest and most straightforward way to deliver information to investors quickly and in a format that allows them to easily review as much or as little detail as may be desired.”170 In response to the SEC’s concerns that investors will not actually go to the Profile Plus on the broker-dealer’s website, the Task Force stated “that is a matter of investor choice, exactly the same as choosing not to read hard copy disclosure or not to listen to oral disclosure.”171 In the Task Force’s view, “[t]he website mode of delivery is . . . critical to effective and timely disclosure of this information for the benefit of investors.”172

Recognizing that some investors do not have Internet access, or may wish not to obtain the information electronically, the Task Force recommended “that the Commission require that broker-dealers offer their customers the option to elect to receive the Profile Plus and dealer disclosure statement in hard copy form.”173 If a customer elects hard copy delivery, “the Commission should require that the broker-dealer transmit the Profile Plus and the dealer disclosure statement by email or in paper form through regular mail or hand-delivery as soon as practicable after the mutual fund recommendation is made.”174

While the Profile Plus may be a cost-effective, efficient means of disclosing required information, not all investors are Internet – or even email – savvy. This is particularly an issue for many senior citizens. Nonetheless, it is obvious that technology has revolutionized the securities industry, and will continue to do so. Thus, brokerage firms should utilize the Internet to provide information in rich yet user-friendly documents like the Profile Plus. Even so, firms should continue to devise other ways of ensuring that all investors – even the Internet-adverse – are able to receive important information regarding potential investments in a more efficient, user-friendly manner.

b. Mutual fund fee structure disclosure

Mutual funds and broker-dealers all are subject to disclosure requirements. With regard to possible discrepancies between fund disclosure and broker-dealer disclosure about revenue sharing arrangements, the Task Force, “urg[ed] the Commission to carefully delineate the respective responsibilities of funds and broker-dealers to provide various items of information to be included in the Profile Plus.”175 Recognizing that cooperation is needed in order to ensure that all relevant information is disclosed as efficiently and effectively as possible, the Task Force noted the importance of “fund management companies and broker-dealers . . . work[ing] with NASD to develop common industry practices for the prompt delivery of information for inclusion in the Profile Plus.”176

c. Rule 12b-1 concerns and issues

About three years ago, the SEC requested comments on how Rule 12b-1 could be improved.177 Specifically, the SEC sought suggestions as to whether 12b-1 should be rescinded or amended “to provide that funds may deduct distribution-related costs directly from shareholder accounts, but not from fund assets.”178 According to the Task Force, “the conversion of Rule 12b-1 fees from the fund level to the shareholder account level would require costly systems changes by fund distributors, transfer agents and intermediaries.”179 The Task Force stated that “it is unclear where this approach would leave directly distributed funds that today pay their distribution costs out of fund assets.”180 The Task Force noted that a “simpler way to make all fund fees and expenses transparent – including the costs of distribution – would be to mandate better point of sale disclosure to the investor. The Task Force’s recommended Profile Plus would accomplish this objective.”181

169 Id. at 5.
170 Id. at 11.
171 Id. at 13.
172 Id.
173 Id.
174 Id.
175 Id. at 14.
176 Id.
177 Id. at 15.
178 Id.
179 Id. at 16.
180 Id.
181 Id.
d. Mutual fund share classes

On June 25, 2003, the NASD published an Investor Alert warning investors to be diligent with regard to the type of mutual share class they purchase.182 Different share classes are characterized by different fee structures and discounts. According to the NASD, “[b]efore purchasing Class B mutual fund shares, [an investor] should determine whether this investment is in [his/her] best interest, and not just in the interest of [the] broker or advisor who may receive higher commissions from the sale of Class B shares than other classes of fund shares.”183 Disclosures should include the following facts:

- Class B shares do not impose a front-end sales charge, but may charge high expenses assessed over the lifetime of the investment.
- Investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.
- Class B shares normally impose a contingent deferred sales charge, which is paid if the shares are sold within a certain number of years.
- 12b-1 fees are typically higher for Class B shares.184
- On October 20, 2006, an NASD Hearing Panel held that suitability of mutual fund B shares is not determined solely by a mathematical computation, but also by other non-economic factors.185

According to the Hearing Panel, where a customer has “received an accurate comparison of the advantages and disadvantages of Class A and Class B shares” and “elected to purchase Class B shares[,]” Enforcement offered no evidence that [the registered representative] failed to disclose the potential financial advantages of Class A shares in a timely and accurate manner, or that, . . . the purchase of Class B shares was clearly against the customer[‘s] financial interest.”186

At this point, given the regulatory scrutiny the B Share fund class has received, it seems less likely that there will be abuses, or at least rampant abuses, associated with the sale of B shares. Still, investors may not fully understand the distinctions between the different share classes. Brokerage firms need to remain vigilant to ensure that all relevant disclosures are being made.

F. Selling Away and Fraudulent Schemes

1. Selling away

“Selling away” is “so named because the registered representative sells a product that is not sanctioned by the firm.”187 While such unsanctioned products are not necessarily fraudulent and may even be excellent investments, the fact that they are not offered through the registered representative’s firm may render them more susceptible to fraudulent and aggressive marketing schemes.

The NASD’s “selling away” rule imposes restrictions on a registered representative participating in securities transactions that are not approved or supervised by his member firm. NASD Rule 3040 sets forth procedures by which brokerage firms may approve private securities transactions, and requires firms to supervise those transactions. Rule 3040 “ensur[es] that member firms are responsible for their brokers’ securities business and so are aware of, approve, and supervise all of their activities.”188

In August 2006, the NASD National Adjudicatory Council affirmed sanctions imposed upon a registered representative who, among other things, had engaged in private securities transactions, for compensation, without giving prior written notice to, and receiving prior written approval from, his firm.189 In the Decision (Complaint No. C9B040033), the Adjudicatory Council found that the registered representative’s “facilitation of the execution of . . . variable annuity contracts through [an outside entity] was ‘outside the regular course or scope’ of his employment.”190

183 Id.
184 Id.
186 Id.
190 Id. at 10.
The registered representative argued that he did not violate the NASD’s “selling away” rule, because the investments he offered to his customers were of a type that his firm authorized him to sell. Further, he asserted that the variable annuity contracts sold were not private security contracts under Rule 3040.191 The Council held, however, that “[e]ven if [the registered representative’s] actions were ‘ordinarily involved’ in such transactions while associated with [his firm], he was not exempt from the notice requirements . . . with respect to the variable annuity contracts purchased [by his client through the outside entity].”192 The Council concluded, “[u]nless the transactions in question were effected through, or with proper notice to his firm, [the registered agent’s] argument simply means that he was violating the NASD’s notice requirement on a regular basis.”193 The Council suspended the registered representative for two years, ordered him to requalify in all capacities, and fined him in the amount of $230,000.194

In February 2006, the NASD National Adjudicatory Council affirmed sanctions against a registered representative who sold unapproved promissory notes away from his firm.195 In the Decision (Complaint No. C01040010), the Adjudicatory Council held that the promissory notes in question were securities.196 The notes were sold to raise capital to conduct business, which was the purchase and resale of automobile installment loan contracts.197 Specifically, the Council stated:

[The registered representative] admits that he received $61,936 in finders’ fees . . . for referring customers to purchase the notes. [He] further admits that he provided no written notice to, and received no written approval from, his firm prior to engaging in the note transactions. Moreover, the . . . notes were unapproved products, and [his firm] prohibited the sale of all promissory notes.”198

As a result of his actions, the registered representative was barred from the industry in all capacities.199

2. Ponzi and pyramid schemes

In 1921, Charles Ponzi made $1 million in three hours.200 Thinking he could capitalize on currency differentials regarding the purchase and sale of international mail coupons, Ponzi “duped thousands of New England residents into investing in a postage stamp speculation scheme.”201 Promising investors a 40% return in just 90 days, Ponzi received a torrent of funds from investors. Ponzi paid off enough of the early investors in order to create an air of legitimacy with regard to the investment. Soon, however, investigators found that Ponzi “had only purchased about $30 worth of the international mail coupons.”202

Named for Charles Ponzi, “Ponzi” schemes, as well as other “pyramid” schemes exhibit the following common characteristics:

1. reliance on funds from new investors to provide returns, commissions, or bonuses to old investors;
2. the need for an inexhaustible supply of new investors;
3. the absence of profitable products or efforts to make profits through productive work. 203

Ponzi or pyramid schemes may take the form of online investment programs.204 The SEC warns investors to “be skeptical of investment opportunities . . . learn[ed] about through the Internet.” One type of pyramid scheme, high yield investment programs, are typically offered online. According to the SEC:205

High-yield investments tend to involve extremely high risk. [Investors should]:

• [n]ever invest in an opportunity that promises "guaranteed" or "risk-free" returns.
• Watch out for claims of astronomical yields in a short period of time.
• Be skeptical of "off-shore" or foreign investments.
• [B]eware of exotic or unusual sounding investments, especially those involving so-called "prime bank" securities.

191  Id.
192  Id.
193  Id.
194  Id.
196  Id.
197  Id.
198  Id. at 6.
199  Id.
201  Id.
202  Id.
205  Id.
Additionally, the SEC warns investors to be wary of other pyramid schemes evidenced by messages that read: “How To Make Big Money From Your Home Computer!!”206 The SEC provides the example of an online promoter who claimed “that investors could ‘turn $5 into $60,000 in just three to six weeks.’”207 The promotion, however, “was nothing more than an electronic version of the classic ‘pyramid’ scheme in which participants attempt to make money solely by recruiting new participants into the program.”208

3. Fraudulent investment schemes and seniors

It is commonly perceived that it is easy for financial advisors to persuade seniors to follow their advice and it is unlikely that such seniors will later question the conduct of their advisors. Seniors continue to be susceptible to “selling away” practices that involve fraudulent schemes, such as Ponzi or pyramid schemes. Therefore, close supervision should be required with regard to financial advisers handling the accounts of senior customers. Further, additional duties – approaching fiduciary duties – may be applicable to financial advisors who are dealing with unsophisticated senior investors.

An NASD Investor Alert, dated January 11, 2001, advised investors “who consider buying promissory notes . . . to check them out thoroughly.”209 The Alert warns that “[o]ften, promissory note schemes target the elderly and their retirement savings.”210 While the Alert focused on promissory notes as discussed above, its admonitions could apply as well to a range of other products targeted at senior citizens. The Alert’s advice is still true today:

- Ask why the seller wants to sell to you.
  - Bona fide corporate promissory notes generally are sold to sophisticated buyers who can do their own research on the company issuing the notes to determine whether the notes are a good deal. The fact that promissory notes are being sold to individual investors is itself a danger signal.

- Check Check Check Check
  - Check with the SEC’s EDGAR Database to see if the notes are registered. (Remember that most promissory notes are securities and have to be registered with the SEC and the state they are sold in, unless they are specifically exempt from registration under law.) Check with your state securities regulators whether the investment and the salesperson are in compliance with your state’s securities laws.
  - Visit the [FINRA] BrokerCheck Web page to see if your broker is registered or has a disciplinary history. Check with the Better Business Bureau where the company issuing the notes is located to find any complaints against the company.

- Broker Role
  - If you are buying through a broker, ask if the note is being sold through the broker’s firm. If not, it is being “sold away” and you will miss important investor protections that flow from the broker’s and the firm’s regulatory obligations.

- Guaranteed Returns
  - Know that a salesperson cannot guarantee a particular return. Even if the note has a fixed interest return, the investment may not pay that amount - or return your principal - to you. Moreover, the seller may say the notes are insured, but not mention that the insurer may not be legitimate - and outside the US and beyond the reach of our laws.

- If you don’t get good answers to all of your inquiries, walk away from the offer and keep your money.211

IV. SUGGESTED BEST PRACTICES

Close review and analysis of the information developed by the numerous studies and task forces that have examined seniors issues in the financial services industry, and the regulators’ views, warnings, rule proposals and enforcement actions, provide important insights into the ways that compliance professionals can focus their efforts on changing and improving their compliance, surveillance, and supervisory policies and procedures to mitigate the risks associated with the Senior Retirement Explosion. Based on the information gathered and the concepts and proposed changes that analysis of the regulators’ efforts and pronouncements bring to mind, we have developed a series of practical ideas and suggested “best practices” for compliance professionals to consider.

207 Id.
208 Id.
209 See NASD Investor Alert, supra note 188.
210 Id.
211 Id.
A. Training

A firm should mandate training for its registered representatives and advisers (“RRs/advisers”) to make them aware of age issues, including how one’s age physically affects the ability to hear, understand, see and retain information that is exchanged in the normal course of the brokerage/advisory relationship. The training should include instruction about signals to alert one about possible changes in comprehension, signs of dementia and the like to make sure the firm is comfortable that the client has the capacity to make decisions about her portfolio. In addition, the firm should consider specific programs to train all RRs/advisers on the firm’s new and special rules, policies and procedures addressing seniors issues. All such training, to the extent feasible, should not merely recite rule requirements, but also include examples that are relevant to the nature of the trainees’ businesses. These training programs, which should be mandatory for both new and existing registered persons, are critical to set the tone and expectations about the firm’s commitment to senior customers. A firm also may consider inviting representatives from senior-related advocacy groups and state and local agencies that serve seniors to speak to its registered persons.

B. Cooperation with Family and Other Professionals

Problems frequently arise when the next generation reviews how the client’s finances have been managed. To the extent feasible, the bridging of the generations through involvement of children in the process of planning once the client reaches a certain age will in many cases aid and protect the client, the family and the firm. In many instances, this may be a sensitive or difficult issue, but affirmative consideration of whether and how this gap might be bridged in each situation, including the development of some written policies and procedures designed to address the issue, seems likely to solve or avoid more problems than such efforts likely would create, if handled properly.

Working with the client’s accountants, estate attorneys, and other professional advisors also will naturally lead to a better understanding of how to invest for the client over her lifetime and create the opportunity to collaborate as to the best course of action as the client’s needs and abilities change over time. Written policies and procedures that promote affirmative consideration of this concept may be in order. Plus, making the discussions of such issues a matter of policy or routine may make it easier to broach such sensitive issues.

To address these issues, a firm should consider policies and procedures designed to encourage its RRs/advisers to seek appropriate ways to involve children and/or beneficiaries of senior customers in the financial planning process and to smooth the transition from the senior customer to those beneficiaries. Such policies and procedures could include:

- procedures for seeking written permission, if and when appropriate and feasible, to contact and consult with children, beneficiaries and other professionals;212
- policies and procedures formalizing arrangements for referrals and collaborations between the RR/adviser and other professionals; and
- the development of an approval process (possibly under the OBA function) for any such collaboration arrangements.

C. Written Materials, Typeface, Type Color

The size of the font used in materials distributed to seniors should be larger -- think of the big number phones one sees to aid with the dialing process for those with poor vision. In addition, studies have shown that certain colors for background and typeface are easier for seniors to read. There is no reason that written materials cannot be optimally printed to allow ease of reading. To address this issue, firms might consider adjusting font, colors of typeface and background and nature of written materials to be provided to senior customers. In addition, it may be appropriate to develop specialized policies and procedures for enhanced communications with senior customers and additional requirements for record-keeping related to same, including confirmatory writings following all meetings and phone calls and limitations on emails or requirements that they be supplemented with mailed written communications.

D. Monitoring of and Cooperation with AARP and Similar Lobbies

A firm should consider designating representatives as delegates to follow the issues about which the AARP, the Alzheimer’s Association, and like groups voice concerns. AARP exists in part to take care of the interests of seniors, so following their agenda would likely be helpful in discharging a firm’s responsibilities to seniors. It may be worthwhile for the firm to appoint a person or committee as the designee for seniors issues, much like the AML designee. Further, a firm and its registered persons may consider being proactive in helping to educate seniors about how to avoid being victims of financial fraud, including making investor education materials prepared by the regulators and other sources available to senior investors.

212 The strictures of Regulation S-P should be taken into account, including disclosure of the conditions under which such contacts would be made and how the information would be used, and the provision of the customer’s right to withdraw consent at any time.
E. Supervision of Seminars and Advertising

Supervisory and compliance practices that have been noted by the regulators as “helpful to consider” in reviewing and updating a firm’s written procedures addressing sales seminars and advertising include the following:213

• The process for reviewing and approving proposed seminars and the advertising and other materials for the seminars was centralized, and included a dedicated compliance person with knowledge of the securities laws and rules with respect to advertising materials. The firm’s policies and procedures clearly set forth the process for proposing seminars and advertising materials, and they were made known to all firm employees. Supervisory reviews of advertising and sales materials generally identified disclosure mistakes and potential problem areas that were corrected prior to the time the advertising materials were to be used.

• Policies and procedures for submitting proposals for sales seminars included specific timeframes for supervisory review and approval. For example, the approval and review process for seminar and advertising material required submissions of all materials three to four weeks prior to the seminar date. This allowed adequate time for supervisors to review and correct disclosure issues and any other issues identified prior to the seminar.

• All advertising material was forwarded to the home office for review and approval prior to use. This firm required information on seminar guest speakers to be forwarded and approved as well.

• One firm had two levels of supervisory approval for seminars and all sales materials and advertisements to be used at those seminars. The branch manager review was the first level of approval. The materials were then sent to the main office to be reviewed and approved by the compliance department.

• Written guidance was provided to all individuals who may be involved in sales seminars – the registered representatives who conduct sales seminars, the branch office manager and other supervisors who review and approve the seminars and sales materials as well as any compliance staff who may also review the seminars and materials prior to use. The guidance provided clear explanations of what was permissible and what was not permissible, both in terms of compliance with the securities laws, and compliance with the firm’s own policies.

• Written checklists were used to aid firm employees in reviewing and approving sales seminar advertisements and sales literature to ensure that the materials used complied with regulatory requirements and the firm’s policies.

• One firm’s procedures required that supervisors or compliance staff make written edits to proposed sales seminar materials or advertising, and required that this marked-up draft be provided along with a final copy of the materials (showing that the changes had been made) to the reviewing official for the permanent file.

• Standardized, pre-approved materials and advertisements were used for sales seminars. The firm’s procedures required that all marketing materials be created at a central level; individual registered representatives were not involved in creating their own seminar materials or advertisements. Registered representatives also used a standard outline for seminars.

• Materials for sales seminars were maintained in a centralized location. A complete package of seminar and advertising materials were filed and maintained in one place, including a copy of the request to host the seminar with indications of approval by the branch office manager and any other authorized approving official. The file included the title of the seminar, date, location, speaker, any guest speakers, the company they represent, the date the approval was given and the list of people who were invited to attend the seminar. The file also contained a list of attendees, whether they were a client or prospect, a photocopy of the actual seminar ad that ran in the newspaper, the approved marketing pieces that were distributed at the seminar, approved copies of the slide presentation and any other information given to attendees.

• Branch managers were expected to attend a percentage of the sales seminars presented by the sales people they supervised.

• “Mystery shoppers” (who were firm employees) were utilized on a random basis to attend sales seminars and to identify potential disclosure and compliance weaknesses, and report any issues back to the direct supervisors of the seminar hosts.

• All registered representatives were required to certify to their branch manager each month that they had provided all advertisements, sales literature, and correspondence items used during the month.

F. New Account Information and Review and Updating of Same

This critical area in the establishment of account relationships and the documentation of essential customer information takes on special significance in the case of senior customers. Because of this significance, a firm should consider specialized procedures for documentation of new account information and the review and periodic updating of same, including:

- requiring in-person meetings to finalize new account form;
- requiring more than one person from the firm to attend such meeting;
- requiring independent documentation of total net worth for all customers over a certain age;
- requiring special supervisory review of all new account forms reporting investment objectives for customers over a certain age more aggressive than “income” (or its substantive equivalent);
- regularized procedures for the detailed review of clients’ financial status, needs and investment objectives as they near retirement age or enter retirement; and
- regularized procedures for seeking to update information regarding the financial status, personal circumstances (including ability to make decisions for themselves) and investment objectives.

G. Principal/Supervisory Responsibility

Given the additional risks associated with senior customer account relationships, it is incumbent on each firm to assure more direct and substantive involvement of direct line supervisors (and the documentation thereof) concerning the opening and handling of senior customer accounts and investments, including:

- mandatory client contact at commencement of customer relationships;
- mandatory client contact once the client reaches retirement age or enters retirement;
- mandatory annual client contact to verify objectives and knowledge of activity in and performance of each senior customer account;
- mandatory periodic supervisor interview of RR/adviser regarding the portfolios of senior customers;
- mandatory prior approval of all, or certain, types of higher risk products or alternative investments;
- more formalized and rigorous procedures for review and approval of direct investments by senior customers;
- for higher risk products (e.g., variable annuities, EIAs), more detailed procedures requiring clients to affirm in writing acknowledgment of receipt of risk disclosure documents and understanding of the identified risks.

H. Other Written Policies and Procedures to Consider

In addition to the proposed changes and additions outlined above, the issues presented by senior customers suggest additional changes to a firm’s written supervisory and compliance procedures. These changes involve limitations on various product offerings and sales practices with respect to senior customers. In terms of the form the limitations take, a firm should consider a variety of alternatives, including: (i) outright prohibitions; (ii) size, volume, dollar amount or similar caps; (iii) requiring prior written customer consent; (iv) requiring participation of a firm supervisor in a sales or related presentation; or (v) requiring prior or prompt post transaction principal review and written approval. The approach that a particular firm takes should be decided after careful analysis of the firm’s particular situation, including its client and product mix, history of complaints, size and resource and related factors. Potential actions include:

- designating a specific individual or department, such as the compliance or legal department, to serve as a central advisory contact for questions about seniors issues, as well as a repository of available resources;
- providing guidance on how to identify, and what to do, if a registered person suspects that her customer is experiencing diminished capacity or is being abused, financially or otherwise, by a family member, caregiver, or other third party;
- banning the use of any designation that includes the word “senior” or “retirement” or maintaining a list of designations approved by a committee including supervisory, legal and/or compliance personnel, based on curriculum, examinations, continuing education requirements, and other relevant factors;
- imposing prohibitions or limitations regarding the sale or exchange of certain types of products to customers over a certain age;
- placing additional and more specific restrictions on the list of approved products for senior customers;
- placing more specific restrictions and requirements for prior written approval of supervisor for any recommendation or sales to senior customers that deviate from the list of approved products or other established parameters concerning investment objective, asset allocation mix, net worth or personal circumstances;
- requiring two persons from the firm to attend any in-person consultations, seminars, dinners, or other sales presentations or similar events targeted at customers over a certain age;
- prohibiting or strictly limiting sales calls on customers in nursing homes, assisted living facilities or similar special care or elder living settings;
• developing more specific and detailed requirements regarding the disclosure (and documentation thereof) of the features, risks and fees of certain products for senior customers;
• mandating secondary, centralized supervisory review of transactions of certain size with or for senior customers, in certain type of product, or other parameters; and
• requiring enhanced and more specific compliance certifications addressed to special policies and procedures addressed to seniors issues.

I. Specialized Surveillance Tools and Exception Reports

Beyond changes to written supervisory procedures, compliance professionals would be well served to consider enhancing their surveillance tools and the exception reports that are generated by their surveillance systems to capture transactions and changes in senior customer accounts that increase the firm’s risk and exposure to regulatory sanction and/or civil litigation. The following are examples of additional detailed exception reports that should be considered:

• losses in senior customer accounts in relation to account/portfolio value;
• losses in senior customer accounts in relation to customer reported net worth;
• percentage of customer reported net worth in alternative or illiquid investments;
• asset allocation mix limits for customer portfolio (or reported net worth);
• changes in reported investment objective;
• failure to change investment objective or income at certain ages; and
• active regular monitoring of fee-based accounts and investment advisory arrangements to ensure continuing suitability for accounts that are not active.

These suggested practices and improvements are not intended to be exhaustive and exclusive. Hopefully, they will spur new ideas for other changes and improvements. Moreover, because of the numerous differences between firms, and the necessity and intrinsic value of tailoring compliance and supervisory policies and procedures to each firm’s business, we expect that new developments and improvements in policies and procedures addressing seniors issues will expand well beyond the scope of these suggestions.

V. CONCLUSION

The Retirement Explosion presents an unprecedented and momentous opportunity for the financial services industry. The needs of seniors for sound investment advice and appropriate investment vehicles are, and will continue to be, critically important to their lives and well-being. These needs provide substantial opportunity for broker-dealers and investment advisers to expand and broaden their financial services businesses. Yet, as is usually the case, such tremendous opportunity comes with risks of potential investor abuse, and pitfalls and potential exposure to liability for wrongful conduct.

The risks, pitfalls and potential exposures are magnified because of the nature and vulnerability of senior customers. Moreover, the regulators’ recent focus on issues, areas of concern and incidents of potential and actual abuse make the need for each firm to proactively address seniors issues real and palpable.

The efforts to refine, tailor and upgrade each firm’s compliance efforts and supervisory policies and procedures to address the specialized and heightened needs and risks of senior customers will involve significant additional costs, time burdens and complexity. Nevertheless, the added costs, time, effort and complexity are an inevitable consequence of the regulators’ focus on seniors issues. They are also necessary burdens to bear in order to effectively, successfully and profitably serve the investment needs of the burgeoning senior population and avoid the all-too-real and expensive risks of litigation and regulatory sanctions that the wave of senior investors seem assured to bring.

At bottom, given the huge impact that seniors will have on the financial services industry in the coming years in terms of both profit and risk, it seems that each firm and its investment, supervisory and compliance professionals have no choice but to proactively address seniors issues in their business models, compliance efforts and supervisory policies and procedures.