PROTECTING CLIENTS WITH DIMINISHED CAPACITY IN THE SECURITIES INDUSTRY: IT'S TRICKY

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Senior investors with diminished capacity are more at risk of falling victim to financial fraud than other investors and the financial industry should fully utilize its power to prevent substantial economic harm to elderly clients. Seniors are susceptible to various forms of dementia.[2] The most common form is Alzheimer's disease, accounting for approximately 60 to 80 percent of dementia cases.[3] An estimated five million Americans suffer from Alzheimer's and that number will grow over the years.[4] Alzheimer's can cause cognitive, behavioral, and mood changes.[5] The most prevalent symptoms are memory loss and confusion.[6] Among the warning signs of Alzheimer's is the inability of sufferers to "perform the financial tasks of daily living and to manage their financial affairs."[7] Because sufferers of Alzheimer's are no longer able to oversee financial matters,[8] these individuals are more susceptible to financial fraud. As a result, these individuals are at the greatest risk of losing a significant amount of their retirement savings and in need of protection.[9]

According to the National Adult Protective Services Association, "financial exploitation occurs when a person misuses or takes the assets of a vulnerable adult for his/her own personal benefit."[10] Fraud accounts for substantial economic losses in the United States. Some estimate that Americans may lose as

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[2] *Types of Dementia*, ALZHEIMER'S ASSOCIATION, http://www.alz.org/dementia/types-of-dementia.asp (last visited July 29, 2015).

[3] *Id.*

[4] Mason Braswell, *Unraveling Minds*, INVESTMENTNEWS (Nov. 3, 2014), http://www.investmentnews.com/article/20141103/FEATURE/141039973/unraveling-minds. The survey was conducted in October 2014. *Id.*

[5] *What is Alzheimer's?*, ALZHEIMER'S ASSOCIATION, http://www.alz.org/alzheimers_disease_what_is_alzheimers.asp#symptoms (last visited July 29, 2015).

[6] *Id.*

[7] *Alzheimer's Disease and Managing Finances*, NATIONAL INSTITUTE ON AGING, https://www.nia.nih.gov/alzheimers/publication/alzheimers-disease-and-managing-finances (last updated Jan. 22, 2015).

[8] Gina Kolata, *Money Woes Can Be Early Clue to Alzheimer's*, N.Y. TIMES (Oct. 30, 2010) (stating that "one of the first signs of impending dementia is an inability to understand money and credit, contracts and agreements").

[9] "Seniors are more dependent than ever on their own investments for retirement." *SEC Staff and FINRA Issue Report on National Senior Investor Initiative*, FINRA (April 15, 2015), (quoting SEC's Office of Compliance Inspections and Examinations Director Andrew J. Bowen), https://www.finra.org/newsroom/2015/sec-staff-and-finra-issue-report-national-senior-investor-initiative.

[10] *What is Financial Exploitation?*, NATIONAL ADULT PROTECTIVE SERVICES ASSOCIATION, http://www.napsa-now.org/get-informed/what-is-financial-exploitation/ (last visited July 29, 2015).

much as $50 billion per year to fraud.[11] It greatly affects the elderly population. With roughly one out of every five Americans 65 years and older being the victim of financial abuse.[12] Consequently, the elderly lose up to $2.9 billion per year from scams.[13] These figures are even likely lower than the true figures since they only account for frauds that are reported, and seniors are "less likely" to report being scammed.[14] Because most victims are retirees, they are not able to personally recoup their losses by working.[15] Alternatively, litigation is also costly and a full recovery is never guaranteed. Thus, fraud prevention is essential.

When discussing the problem of diminished capacity in the financial industry, Robert Colby, the Financial Industry Regulatory Authority's ("FINRA") chief legal officer, stated, "Age-related issues are really tricky."[16] Complexities aside, something must be done to protect those who have lost the ability to protect themselves. Regulators, self-regulatory organizations ("SROs"), government bodies, and private firms have begun to answer the call. But there is still a long way to go.

I. THE FINANCIAL INDUSTRY'S ROLE IN THE DIMINISHED CAPACITY PROBLEM

Firms are in the perfect position to recognize signs and symptoms of diminished capacity and dementia with respect to their clients' ability to handle their finances and prevent elder financial abuse.[17] Financial advisors may actually become aware of suspicious activity before family and friends.[18] For instance, according to Susan Axelrod, Executive Vice President of Regulatory Operations at FINRA, among the warning signs of Alzheimer's disease is "changing a long term investment strategy suddenly."[19] Other signs of diminished capacity include, "frequently repeating orders or questions and trouble understanding basic financial terms and math concepts."[20] Because financial advisors regularly interact with their clients,

[11] *What Do Con Artists Know?*, FINRA, http://www.finra.org/investors/what-do-con-artists-know (last visited July 29, 2015).

[12] E.S. Browning, *Financial Scammers Increasingly Target Elderly Americans*, WALL ST. J. (Dec. 23, 2013), http://www.wsj.com/articles/SB10001424052702303330204579248292834035108. This is the equivalent of more than seven million Americans. *Preventing Elder Investment Fraud*, INVESTOR PROTECTION TRUST, http://www.investorprotection.org/protect-yourself/?fa=protect-seniors (last visited July 29, 2015).

[13] Braswell, *supra* note 4.

[14] *Fraud Target: Senior Citizens*, FEDERAL BUREAU OF INVESTIGATION, https://www.fbi.gov/scams-safety/fraud/seniors (last visited July 29, 2015).

[15] Teresa Verges, *Legal Ethics and an Aging Population: Securities Practitioners' Rules in Preventing Financial Exploitation of the Elderly, in* SECURITIES ARBITRATION 2015 183, 186 (Practising Law Institute, 2015).

[16] Matthias Rieker, *A Thorny Trade-Off in Protecting Older Investors*, WALL ST. J. (June 24, 2015), http://blogs.wsj.com/totalreturn/2015/06/24/a-thorny-trade-off-in-protecting-older-investors/.

[17] *See* Naomi Karp & Ryan Wilson, *Protecting Older Investors: The Challenge of Diminished Capacity*, AARP PUBLIC POLICY INSTITUTE 17 (Nov. 2011), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/cons_prot/2011/rr2011-04.pdf.

[18] *See id.*

[19] Alzheimer's and Money Problems, CBS NEWS (Nov. 17, 2010), http://www.cbsnews.com/videos/alzheimers-and-money-problems/.

[20] *See* Karp & Wilson, *supra* note 17.

they can identify these signs before nearly anyone else.[21] In *InvestmentNews*'s recent survey, one financial advisor recalled a client that "will ask me to do something out of the ordinary, such as request a *major* withdrawal from his IRA to make a frivolous purchase. But then the next time I see him, he seems fine."[22] The question now is whether financial advisors are prepared to handle such situations.

Although the financial industry has certain procedures in place, more needs to be done to address the problem of diminished capacity. In fact, financial advisors and compliance officers ("COs") recognize that firms should implement additional measures. In a recent survey conducted by *InvestmentNews*, one financial advisor stated that although the industry is aware that the diminished capacity issue would continue to grow, "regulators and institutions are making it hard to assist the client and their families."[23] Regulatory rules pose a challenge because they limit what financial advisors can do when they suspect their elderly client is victim of fraud. Thus, both firms and regulatory agencies need to act promptly to empower good brokers.

While firms and their brokers should be prepared to assist their elderly clients with dementia, recent surveys suggest that the financial industry as a whole is not. *InvestmentNews*'s recent survey of 200 advisors analyzed their exposure to clients with dementia and their preparedness to help such clients.[24] According to the survey, approximately two-thirds "work with a household where a client is suffering from, or showing signs of, cognitive decline."[25] Nonetheless, only 51% of advisors felt prepared to assist a client with dementia.[26] Fidelity Investments conducted a similar survey of 350 advisors.[27] Eighty-four percent of those surveyed responded that their clients had Alzheimer's or were showing signs of the disease.[28] However, 96% of advisers felt unprepared.[29] These figures make a compelling case that firms are presently not doing enough to educate their brokers to better assist clients with dementia.

II. STEPS IN THE RIGHT DIRECTION

Some firms have made efforts to address the problem of diminished capacity. These efforts, however, are not uniform across the industry. Since firms are voluntarily implementing these measures, making procedures an industry standard would not place any undue burden on firms and elderly clients with diminished capacity would be better protected. Some steps taken so far include: additional training, powers of attorney, and authorization.

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[21] *Id.*

[22] Braswell, *supra* note 4.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] Kolata, *supra* note 8.

[28] *Id.*

[29] *Id.*

A. Additional Training

Those in the financial industry believe firms should require training on this issue,[30] but a study revealed that only 33% of advisors and 25% of COs receive required training.[31] Some firms, such as Edward Jones and Merrill Lynch, are providing their advisors with additional training.[32] Edward Jones established a mandatory educational course on "investment issues affecting seniors, how to deal with clients with diminished decision-making capabilities and how to identify when an elderly client may be vulnerable to exploitation."[33] Further, Morgan Stanley's risk department provides its brokers with in-person training on how to detect and report elder abuse.[34]

The industry should be required to provide their employees with diminished capacity training, such as how to spot signs of diminished capacity or elder abuse, who to report it to, and how to handle recommendations and transactions to and from persons suspected of diminished capacity or those abusing the elder whom may have powers of attorney or discretion over the account. All firms, small or large, do not have to reinvent the wheel. As mentioned above, some firms already have training programs in place. Firms that currently do not offer training can easily follow their lead. Providing training is not an onerous burden on firms and should be an industry standard.

B. Powers of Attorney

A power of attorney ("POA") is a legal document that would enable a third-party (the agent) to act on behalf of a client (the principal) under certain circumstances.[35] A financial POA would allow an agent to make financial decisions for the principal should he or she suffer from diminished capacity.[36] Since diminished capacity can affect a client's ability to make decisions concerning their investments, it is important for firms to be aware of the existence of a POA. The AARP's Public Policy Institute conducted a study of 360 financial advisors and 166 compliance officers to examine the issues involving diminished capacity.[37] According to the study, the firms' most common practice was "ascertaining whether a client has a power of attorney."[38] Nevertheless, the SEC's Office of Compliance Inspections and Examinations and FINRA reported that a mere 30% of firms currently obtain information regarding the existence of a

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[30] Karp & Wilson, *supra* note 17, at 23.

[31] *Id.*

[32] Braswell, *supra* note 4.

[33] Matthias Rieker, *Firms Combating Elderly Financial Abuse*, WALL ST. J. (April 29, 2014), http://www.wsj.com/articles/SB10001424052702304393704579531481695463924.

[34] *Id.*

[35] *Financial Power of Attorney*, AARP, http://www.aarp.org/relationships/caregiving-resource-center/info-11-2010/lfm_financial_power_of_attorney.html (last visited July 29, 2015).

[36] *Planning for Diminished Capacity and Illness*, CONSUMER FINANCIAL PROTECTION BUREAU 2 (June 2015), http://files.consumerfinance.gov/f/201505_cfpb_consumer-advisory-and-investor-bulletin-planning-for-diminished-capacity-and-illness.pdf.

[37] Karp & Wilson, *supra* note 17, at 2.

[38] *Id.*

durable POA.[39] Industry rules do not require firms to obtain information about POA. Since it would not take a lot of effort to ask this important question, it would not be unreasonable to require firms to obtain POA information.

Even if agents under a POA make financial decisions, firms cannot be complacent because financial abuse can still occur. As Wells Fargo's Director of Elder Client Initiatives Robert Long recognized, some agents "rather than using the money for the benefit of the elderly client, take[] advantage and use[] it for themselves."[40] Because of the possibility of abuse, 86% of advisors would monitor accounts once an agent under power of attorney takes over.[41] An additional protective measure is sending confirmations and account statements to the agent and client.[42] Firms should flag accounts that are controlled by agents acting under power of attorney. This extra level of supervision would ensure that these accounts are managed properly and would help prevent any future losses if a fraud is detected early.

C. Authorizations

An *InvestmentNews* survey participant stated that his/her firm was "building permission forms authorizing [them] to contact family or other professionals to discuss accounts."[43] This is similar to a "diminished capacity letter," which would allow a firm to contact a family member to act as a fiduciary if a client shows signs of diminished capacity.[44] Merrill Lynch created a contact authorization form that would allow brokers to ask the designated contact about "a client's whereabouts or health issues—but not about a client's investments."[45]

In fact, the Securities and Exchange Commission ("SEC") and the Consumer Financial Protection Bureau ("CFPB") seem to endorse this strategy.[46] In a joint investor bulletin, the SEC and CFPB encouraged elderly investors to "provide [their] financial professionals with trusted emergency contacts."[47]

While these discussions with a client are not easy ones, they are critically important. It would not require much effort on the industry's part to have clients provide the name of a trusted individual if diminished capacity becomes an issue. A simple question on an already existing new account application or the creation of a new authorization form would be easy and inexpensive to implement. Firms can also ask clients to designate an individual when they update their account information.

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[39] *National Senior Investor Initiative*, U.S. SECURITIES AND EXCHANGE COMMISSION 17 (April 2015), http://www.sec.gov/ocie/reportspubs/sec-finra-national-senior-investor-initiative-report.pdf.

[40] Mark Abrams, *Wells Fargo Aims to Solve Rise in Elder Financial Abuse*, CBS PHILLY (July 14, 2015), http://philadelphia.cbslocal.com/2015/07/14/wells-fargo-aims-to-solve-rise-in-elder-financial-abuse/.

[41] Karp & Wilson, *supra* note 17, at 26.

[42] *Id.*

[43] Braswell, *supra* note 4.

[44] *Id.*

[45] Rieker, *supra* note 33.

[46] *Investor Bulletin and Consumer Advisory: Planning for Diminished Capacity and Illness*, U.S. SECURITIES AND EXCHANGE COMMISSION (June 1, 2015), http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-consumer-advisory-planning-diminished-capacity-illn.

[47] *Id.*

III. PROTECTING DIMINISHED CAPACITY CLIENTS FROM BROKERS

There are times when elderly clients with dementia need to be protected from unscrupulous brokers. For example, an *InvestmentNews* survey participant recalled having to intervene "when [the firm] felt older clients were being taken advantage of by very hard-selling salespeople pushing unneeded products to [their] clients."[48] In a particularly shocking case, FINRA recently filed a complaint against a former UBS Wealth Management broker for taking advantage of his client with Alzheimer's. John Waszolek allegedly attempted to obtain a power of attorney for his client and eventually named himself beneficiary of his client's trust. While the funds were ultimately not distributed to Mr. Waszolek, this story highlights the potential abuse from trusted professionals, and not just from strangers.

Even though a client may seek redress through arbitration or litigation, it would be optimal for it to never happen in the first place. First, a full award is never guaranteed and a client may not recover all of his or her losses. Second, the process of seeking recovery may take its toll on an elderly client, both financially and emotionally. If financial abuse is prevented, this could all be avoided.

IV. LEGISLATIVE MEASURES TO ADDRESS DIMINISHED CAPACITY

While firms are adopting measures to address their growing concern regarding elderly clients with diminished capacity, states are also passing legislation intended to protect those clients. Thus far, three states have given brokers authorization to delay or refuse to execute certain transactions if they suspect financial exploitation.[49] Delaying transactions may protect a client's assets. For instance, one advisor believed that a transaction was a scam, but was forced to execute the transaction by state regulators.[50] As a result, the client "never saw the rewards—or ever got the money back."[51] Therefore, delayed transactions may be an effective investor protection tool.

While delayed transactions may protect a person's assets if they are in fact victims or potential victims of financial exploitation, an issue may arise where a broker may delay or refuse to execute a transaction that "may be valid and well-reasoned requests by older clients."[52] The consequences may be that firms fail to "get the best possible prices for clients' securities . . . after finding out the delayed transaction is legitimate."[53] Thus, Delaware, Missouri, and Washington passed legislation to afford brokers with protection from liability if they delay or refuse to execute certain transactions.[54]

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[48] Braswell, supra note 4.

[49] Rieker, *supra* 16.

[50] Rieker, *supra* note 33.

[51] *Id.*

[52] Rieker, *supra* note 16.

[53] Susan Barlyn & Elizabeth Dilts, *FINRA to Clarify Firms' Duties in Curbing Elder Abuse*, REUTERS (June 10, 2015), http://www.reuters.com/article/2015/06/10/us-wealth-summit-finra-dementia-idUSKBN0OQ2CF20150610. FINRA to Clarify. This was the case for one elderly woman who won an arbitration award against her brokerage firm for stopping a transaction that hurt her economically. Rieker, *supra* note 16.

[54] Rieker, *supra* note 16.

Washington was the first state to pass legislation regarding possible financial exploitation of seniors.[55] Washington gives financial institutions the discretion if they believe that "financial exploitation of a vulnerable adult may have occurred, may have been attempted, or is being attempted . . . to refuse a transaction."[56] Financial institutions have the authority to exercise this discretion if an investigation is pending[57] or upon information from the "department, law enforcement, or the prosecuting attorney's office."[58] If a security is involved, the financial institution's refusal will expire after 10 days.[59] If a firm or employee refuses a transaction in good faith, they are granted immunity from "criminal, civil, and administrative liability."[60] Washington requires firms to provide their employees with training, which includes "recognition of indicators of" and "steps employees may take to prevent suspected" financial exploitation of a vulnerable adult."[61] Delaware requires firms to report any "past, current, or attempted financial exploitation" to state agencies,[62] but does not require firms to hold a transaction."[63] In the event that a firm does or does not hold a transaction, they are protected from any liability.[64] Missouri similarly enables a broker to stop a transaction for 10 days without repercussions.[65] Unlike Delaware and Washington, Missouri also allows firms to contact an "immediate family member" or "agent under a power of attorney."[66]

V. FINRA AND THE SEC'S GUIDANCE ON DIMINISHED CAPACITY

FINRA's Chairman and CEO Richard Ketchum recently recognized that this was a "high priority" issue.[67] The financial industry seeks to implement "temporary holds" on transactions that may be a result of undue influence or a client's diminished capacity.[68] Consequently, FINRA and the SEC are working on providing brokers with guidelines on delayed transactions.[69] For now, FINRA Regulatory Notice 07-43

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[55] Washington's law passed in 2010. Rick A. Fleming, *Protecting Elderly Investors from Financial Exploitation: Questions to Consider*, U.S. SECURITIES AND EXCHANGE COMMISSION (Feb. 5, 2015), http://www.sec.gov/news/speech/protecting-elderly-investors-from-financial-exploitation.html.

[56] WASH. REV. CODE ANN. §74.34.215(1) (West 2010).

[57] *Id.*

[58] §74.34.215(2).

[59] §74.34.215(5)(a).

[60] §74.34.215(7).

[61] WASH. REV. CODE ANN. §74.34.220(3)(West 2010).

[62] DEL. CODE ANN., §3910(c)(2014).

[63] §3910(e).

[64] §3910(d).

[65] 2015 Mo. Legis. Serv. S.B. 244 (West No. 72).

[66] *Id.*

[67] Barlyn & Dilts, *supra* note 53.

[68] *Id.*

[69] *Id.*

seems to set the current standard, but as securities industry-related studies and reports on aging and diminished capacity increase, it is likely more rules and guidelines will ultimately be issued.[70]

VI. CONCLUSION

Diminished capacity is an existing problem that will continue to grow as the Baby Boomer population ages. While some firms have measures in place to address the problem, surveys show that not all financial advisors feel prepared to help clients with diminished capacity. Current procedures at firms and delayed transactions may help protect elderly clients. However, those clients will not receive the most protection if other firms do not take further steps. Thus, a solution would be to make measures uniform by imposing an industry standard. Firms that fail to implement training and procedures may find themselves in litigation or arbitration with their elderly clients or their heirs, not to mention the scrutiny of regulators and self-regulating organizations.

[70] SEC Office of Compliance Inspections and Examinations and FINRA Report on National Senior Investor Initiative (April 15, 2015); AARP Public Policy Institute, *Protecting Older Investors: The Challenge of Diminished* Capacity (November 2011); Joint study with National Committee for the Prevention of Elder Abuse and the Center for Gerontology at Virginia Polytechnic Institute and State University; MetLife Mature Market Institute, *The MetLife Study of Elder Financial Abuse: Crimes of Occasion, Desperation and Predation Against America's Elders* (June 2011); MetLife Mature Market Institute, *Broken Trust: Elders, Family & Finances*, (March 2009); SEC Office of Compliance Inspections and Examinations, NASAA and FINRA, *Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Service Firms in Senior Investors* (September 22, 2008), as we as its addendum in 2010, available at http://www.sec.gov/spotlight/seniors/seniorpracticesreport092208.pdf; and http://www.sec.gov/spotlight/seniors/seniorpracticesreport081210.pdf; SEC Office of Compliance Inspections and Examinations, NASAA and FINRA, *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 2007), available at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.