

Senior Investors

September 2007

FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers

Executive Summary

One of FINRA's priorities is the protection of senior investors, as well as Baby Boomers who are at or approaching retirement.¹ FINRA's efforts in this area include investor education, member education and outreach, examinations and enforcement. The purpose of this *Notice* is to urge firms to review and, where warranted, enhance their policies and procedures for complying with FINRA sales practice rules, as well as other applicable laws, regulations and ethical principles, in light of the special issues that are common to many senior investors. The *Notice* also highlights, for the consideration of FINRA's member firms, a number of practices that some firms have adopted to better serve these customers.

Questions concerning this *Notice* may be directed to:

- Laura Gansler, Associate Vice President, Office of Emerging Regulatory Issues, at (202) 728-8275;
- James Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; and
- John Komoroske, Vice President, Office of Investor Education, at (202) 728-8475.

Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Continuing Education
- Legal
- Registered Representatives
- Senior Management

Key Topic(s)

- Baby Boomers
- Communications with the Public
- Designations and Credentials
- Diminished Capacity
- Fraud
- Retirement
- Sales Practices
- Seniors
- Suitability

Referenced Rules & Notices

- NASD IM-2310-3
- NASD Rule 2110
- NASD Rule 2210
- NASD Rule 2310
- NTM 96-86
- NTM 99-35
- NTM 03-71
- NTM 04-30
- NTM 04-89
- NTM 05-26
- NTM 05-59
- NTM 06-38
- NYSE Information Memo 05-54
- NYSE Rule 472



Discussion

The number of Americans who are at or nearing retirement age is growing at an unprecedented pace. The United States population aged 65 years and older is expected to double in size within the next 25 years.² By 2030, almost 1 out of every 5 Americans—approximately 72 million people—will be 65 years old or older.³ Those who are 85 years old and older are now in the fastest-growing segment of the U.S. population.⁴ At the same time, Americans are living longer than ever, meaning that retirement assets have to last longer than ever, too. Moreover, fewer and fewer retirees and pre-retirees can rely on traditional corporate pension plans to provide for a meaningful portion of retirement needs. Therefore, the financial decisions made by those who are at or nearing retirement are more important than ever before.

FINRA understands that, as with other investors, levels of wealth, income and financial sophistication vary among older investors. FINRA does not have special rules for senior customers. Firms owe all their customers the same obligations and duties. However, in executing those duties, age and life stage (whether pre-retired, semi-retired or retired) can be important factors, and firms should make sure that the procedures they have in place take these considerations into account where appropriate. Two areas of particular concern to FINRA are the suitability of recommendations to, and communications aimed at, older investors.

Suitability

NASD Rule 2310 requires that in recommending “the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable” for that customer, based on “the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.” The rule also requires that, before executing a recommended transaction, a firm must make reasonable efforts to obtain information concerning the customer’s financial status, tax status, investment objectives and “such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.”

Although the rule does not explicitly refer to a customer’s age or life stage, both are important factors to consider in performing a suitability analysis. As investors age, their investment time horizons, goals, risk tolerance and tax status may change. Liquidity often takes on added importance. And, depending on their particular circumstances, seniors and retirees may have less tolerance for certain types of risk than other investors. For example, retirees living solely on fixed incomes may be more vulnerable to inflation risk than those who are still in the workforce, depending on the number of years those retirees are likely to rely on fixed incomes. Likewise, investors whose investment time horizons afford less time or opportunity to recover investment losses may be disproportionately affected by market fluctuations.

Therefore, firms cannot adequately assess the suitability of a product or transaction for a particular customer without making reasonable efforts to obtain information about the customer's age, life stage and liquidity needs. Other questions to consider include:

- Is the customer currently employed? If so, how much longer does he or she plan to work?
- What are the customer's primary expenses? For example, does the customer still have a mortgage?
- What are the customer's sources of income? Is the customer living on a fixed income or anticipate doing so in the future?
- How much income does the customer need to meet fixed or anticipated expenses?
- How much has the customer saved for retirement? How are those assets invested?
- How important is the liquidity of income-generating assets to the customer?
- What are the customer's financial and investment goals? For example, how important is generating income, preserving capital or accumulating assets for heirs?
- What health care insurance does the customer have? Will the customer be relying on investment assets for anticipated and unanticipated health costs?

Firms should carefully consider the risk of a product with the age and retirement status of the customer in mind, including its market, inflation and issuer credit risk. Investment involves varying degrees of risk and reward. For many investors who are at or nearing retirement, there can be a temptation to reach for yield to maximize retirement income without the appreciation of the concomitant risk. Moreover, it can be difficult for some investors to fully appreciate the risks of certain products or strategies, particularly if they are concerned about running out of money. Yet, especially when investments involve retirement accounts or lump-sum pension plan payments, taking undue risks with funds needed to last a lifetime can be financially disastrous.

Firms do not have an obligation to shield their customers from risks that customers want to take, but they are required to fully understand the products recommended by their registered representatives, to give their customers a fair and balanced picture of the risks, costs and benefits associated with the products or transactions they recommend and recommend only those products that are suitable in light of the customer's financial goals and needs.⁵

This does not mean that all seniors are, or should be, risk-averse, or that any particular product, per se, is unsuitable for older investors. However, certain products or strategies pose risks that may be unsuitable for many seniors, because of time horizon

considerations, liquidity, volatility or inflation risk. Therefore, FINRA's examiners are focusing on recommendations to seniors, particularly those that involve the following:

- Products that have withdrawal penalties or otherwise lack liquidity, such as deferred variable annuities, equity indexed annuities, some real estate investments and limited partnerships;
- Variable life settlements;
- Complex structured products, such as collateralized debt obligations (CDOs);
- Mortgaging home equity for investment purposes; and
- Using retirement savings, including early withdrawals from IRAs, to invest in high-risk investments.

Many of these have been the subject of separate rulemaking or other guidance from FINRA in the past. For example, FINRA has repeatedly stated that variable annuities are generally considered to be long-term investments and are therefore typically not suitable for investors who have short-term investment horizons. This is true even of some variable annuities that offer riders specifically designed for seniors, including those offering guaranteed life benefits.⁶ We also have issued guidance on the suitability of variable life settlements, which are generally aimed at investors over the age of 70;⁷ and the use of home equity for investment purposes.⁸ FINRA also is concerned about recommendations that investors use retirement savings, in some cases by making early withdrawals from IRAs pursuant to Section 72(t) of the Internal Revenue Code, to make unsuitable alternative investments.⁹

As we have in the past, we also caution firms that a customer's net worth alone is not determinative of whether a particular product is suitable for that investor, even when the investor qualifies as an accredited investor under Regulation D of the Securities Act of 1933. Over-reliance on net worth is particularly problematic where an investor meets the accredited investor standard based largely on home values, which may represent the largest asset of many senior investors.¹⁰ Simply put, eligibility does not equal suitability.¹¹

Firms also are reminded that their suitability obligation applies to institutional customers, as well as retail customers, although the scope of that obligation varies depending on whether the institution is able to independently assess the risk associated with a particular recommendation and is in fact exercising independent judgment.¹² FINRA is concerned about the suitability of recommendations to some pension plans, particularly recommendations involving relatively new, complicated or high-risk asset classes, such as leveraged exchange-traded funds (ETFs) or the equity tranches of some collateralized mortgage obligations (CMOs). As NASD IM-2310-3 points out, even institutional customers that have the general capability to assess risk may not be able to understand a particular instrument, particularly a product that is new or that has significantly different risk and volatility characteristics than other investments made by the institution. Therefore, in making recommendations to institutional customers, including pension plans, firms should consider both the general ability of the institution to independently assess investment risk, and whether the customer understands the particular product well enough to exercise that ability with respect to the recommendation.

Communications with the Public

Senior Designations and Credentials

FINRA also is concerned about the proliferation of professional designations, particularly those that suggest an expertise in retirement planning or financial services for seniors, such as “certified senior adviser,” “senior specialist,” “retirement specialist” or “certified financial gerontologist.” The criteria used by organizations that grant professional designations for investment professionals vary greatly. Some designations require formal certification, with procedures that include completion of a detailed and rigorous curriculum focused on financial issues, culminating with one or more examinations, as well as mandatory continuing professional education. On the other end of the spectrum, some designations can be obtained simply by paying membership dues. Nonetheless, seniors may be led to believe that these individuals are particularly qualified to assist them based on such designations. A recent FINRA Investor Education Foundation-sponsored survey found that a quarter of senior investors surveyed were told by an investment professional that the investment professional was specially accredited to advise them on senior financial issues, and a half of those investors were more likely to listen to the professional’s advice because of it.

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 antifraud provisions of the federal securities laws. In addition, some states prohibit or restrict the use of senior designations.¹³

NASD Rule 2210 and NYSE 472 prohibit firms and registered representatives from making false, exaggerated, unwarranted or misleading statements or claims in communications with the public. This prohibition includes referencing nonexistent or self-conferred degrees or designations or referencing legitimate degrees or designations in a misleading manner. Firms therefore must have adequate supervisory procedures in place to ensure that their registered representatives do not violate this requirement. As with all supervisory procedures, these procedures should be written, clearly communicated to employees, and effectively enforced. And, they should cover how approved designations may be used.

Some firms FINRA surveyed in connection with the preparation of this *Notice* ban the use of any designation that includes the word “senior” or “retirement.” Others maintain a list of approved designations, and a registered representative wishing to use a designation not on the list must submit it for review by a committee consisting of principals, compliance officers and/or legal department personnel. Criteria used by committees to review proposed designations include the curriculum, examinations and continuing education components. To help investors and firms understand professional designations, FINRA maintains a database of such designations and the qualifications, if any, that are needed to obtain them at <http://apps.finra.org/DataDirectory/1/prodesignations.aspx>. Please note, however, that FINRA does not approve or endorse any professional designation, and it maintains the list solely to assist in the evaluation of the listed designations.¹⁴

In addition to senior designations, FINRA notes that some third-party vendors are marketing ghostwritten books on senior investing to registered representatives as tools to establish credibility. Holding oneself out as the author of a book on senior investing, and therefore an expert, could violate a number of rules, including NASD Rules 2110, 2120 and 2210, and NYSE Rule 472.

High-Pressure Sales Seminars Aimed at Seniors

Another area of concern to FINRA and other regulators is the use of aggressive or misleading sales tactics aimed at seniors, particularly the use of "free lunch" seminars that use high-pressure sales tactics to promote products that may not be suitable for all persons in attendance. Such high-pressure tactics include attempts to create an artificial or inappropriate sense of urgency around major decisions or commitments (e.g., the use of phrases such as "limited time offer" or "you have to sign up today") or that heighten or exaggerate typical fears of older investors (e.g., the return of double-digit inflation or becoming financially dependent on family members). In response to these concerns, in May 2006, FINRA conducted a series of on-site examinations of broker-dealers that offer so-called "free lunch" sales seminars aimed at seniors. Other regulators simultaneously conducted similar examinations of investment advisers and other firms that offer such seminars.

In the course of the coordinated examinations, regulators found 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). The full discussion of the regulators' findings is presented in *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (Report), available at www.finra.org/reports.

FINRA will continue to follow up on the examination findings that relate to its members and will bring disciplinary actions where warranted. We also will continue to pay particular attention to the conduct of firms and their registered representatives in connection with sales seminars that are aimed primarily at seniors. We therefore urge firms to review their policies and procedures relating to sales seminars to make sure they are adequate. In doing so, firms should consult Appendix A of the Report, which contains detailed best practices for supervising sales seminar activities. These practices were identified by regulators in the course of the examinations as elements of effective supervisory procedures.

Diminished Capacity and Suspected Financial Abuse of Seniors

In addition to the regulatory concerns discussed above, there are other issues that firms sometimes encounter when dealing with senior investors. One of the most troubling to the firms we surveyed is that of investors who exhibit signs of diminished mental capacity. Unfortunately, this difficult and sensitive issue is likely to become more common as the ranks of older seniors grow: a recent study published by the National Institute on Aging reveals that impaired cognition affects approximately 20 percent of people aged 85 years or older.

Another troubling issue is suspected financial—and sometimes mental or physical—abuse of senior customers by their family members or caregivers. Financial abuse is difficult to define, and therefore, difficult to recognize. In general terms, it is the misuse of an older adult's money or belongings by a relative or a person in a position of trust. Red flags can include sudden, atypical or unexplained withdrawals; drastic shifts in investment style; inability to contact the senior customer; signs of intimidation or reluctance to speak in the presence of a caregiver; and isolation from friends and family.

These sensitive issues were raised repeatedly by the firms we surveyed for this *Notice*, and we include in this *Notice*, for the consideration of other FINRA members, some of the steps that firms, as a matter of sound business practice and as a way of serving their senior customers, are taking to address them. In doing so, we are not suggesting that firms are required to take these steps, including developing special written supervisory procedures for servicing senior customers. Firms and clients differ, and policies and procedures that work well for one firm may not be appropriate for another. The steps include:

- Designating a specific individual or department, such as the compliance or legal department, to serve as a central advisory contact for questions about senior issues, as well as a repository of available resources.
- Providing written guidance to employees on senior-related issues, such as how to identify and/or what to do if they suspect their customer is experiencing diminished capacity or is being abused, financially or otherwise, by a family member, caregiver or other third party.

For example, one firm FINRA surveyed has very detailed procedures requiring its employees to immediately notify their branch manager, supervisor or another designated firm employee if they suspect abuse. Under the firm's procedures, that person in turn must notify the firm's legal department, which may decide to report the suspected abuse to the appropriate state agency; restrict activity in the account and/or take any action necessary to comply with appropriate court orders. In addition, the firm requires that the contact with the legal department be documented in the customer's file in accordance with the firm's record retention schedule. The supervisor or branch manager also is instructed to contact local emergency services if immediate physical abuse of a senior investor is suspected.

- Asking, either at account opening or at a later point, whether the customer has executed a durable power of attorney. (Some firms report that it is easier to have conversations with their customers about such sensitive issues as a matter of routine.)

- Asking, either at account opening or at a later time, whether the customer would like to designate a secondary or emergency contact for the account whom the firm could contact if it could not contact the customer or had concerns about the customer's whereabouts or health. (To avoid violating Regulation S-P, firms would have to clearly disclose to the customer the conditions under which the information would be used, and the customer would have the right to withdraw consent at any time.)
- Asking the customer if he or she would like to invite a friend or family member to accompany the customer to appointments at the firm.
- Informing the customer (where appropriate) that, in the firm's view, a particular unsolicited trade is not suitable for the customer.
- Reminding registered representatives that it is important when dealing with customers, particularly seniors, to base recommendations on current information.
- Offering training to help registered representatives understand and meet the needs of older investors, including proper asset allocation, liquidity demand and longevity needs, as well as the possible changes in their suitability profiles. Some relevant materials are available at www.finra.org and www.saveandinvest.org. Further, some firms have invited representatives from senior-related advocacy groups, the Alzheimer's Association, and state and local agencies that serve seniors to speak to their employees. Organizations that can help firms locate local experts on senior issues include the National Association of State Units on Aging (www.nasua.org), the National Association of Area Agencies on Aging (www.n4a.org) and AARP (www.aarp.org).

Investor Education

Finally, we urge firms to be proactive in helping to educate customers about how to avoid being victims of financial fraud, including making investor education materials, prepared by FINRA, the SEC, state regulators, the firm or another source, available to senior investors.¹⁵ Registered representatives are often in a unique position to help customers learn about how to avoid fraudulent solicitations. We encourage our member firms and associated persons to talk with all of their customers, particularly seniors and others at high risk of being targeted, about how to spot scams and protect themselves and their families from financial fraud.¹⁶

Conclusion

Given the unprecedented number of investors who are at or nearing retirement age, protecting older investors is a priority for FINRA, and we urge firms to make it a priority, as well. We recognize that seniors are not all alike, and we stress that all investors are entitled to honesty and integrity from their broker-dealers. We remind firms to make sure that the policies and procedures that they do have, as well as relevant training materials, adequately take into account the special needs and concerns that are common to many investors as they age.

Endnotes

- 1 For ease of reference, this *Notice* refers to both categories as seniors unless the context requires a more specific reference.
- 2 See Wan He *et al.*, U.S. Census Bureau, Current Population Reports, P23-209, *65+ in the United States: 2005*, U.S. Government Printing Office, Washington, D.C. (2005), available at www.census.gov/prod/2006pubs/p23-209.pdf.
- 3 *Id.*
- 4 See Wan He *et al.*, U.S. Census Bureau, Current Population Reports, P23-209, *65+ in the United States: 2005*, U.S. Government Printing Office, Washington, D.C. (2005), available at www.census.gov/prod/2006pubs/p23-209.pdf. See also Frank B. Hobbs, U.S. Census Bureau, *The Elderly Population*, U.S. Government Printing Office, Washington, D.C. (2001), available at www.census.gov/population/www/pop-profile/elderpop.html.
- 5 A broker must refrain from making an unsuitable recommendation even if the customer expressed an interest in engaging in the inappropriate trade or asked the broker to make the recommendation. See, e.g., *Dane S. Faber*, Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (Feb. 10, 2004).
- 6 See NASD *Notice to Members (NTM) 96-86* (December 1996) and *NTM 99-35* (May 1999). In *NTM 99-35* and in NYSE *Information Memo 05-54* (August 11, 2005), we outlined a series of "best practices" and critical criteria relating to sales of variable annuities. While some members have voluntarily adopted many of those practices, others have not. Because some firms continue to engage in problematic sales practices in this area, and some investors continue to be confused by certain features of these products, we have adopted a rule (Rule 2821) that establishes suitability, disclosure, principal review, and supervisory and training requirements, all tailored specifically to transactions in deferred variable annuities. See Exchange Act Release No. 56375 (Sept. 7, 2007) (SR-NASD-2004-183). See also www.finra.org/RulesRegulation/RuleFilings/2004RuleFilings/P012781.
- 7 See *NTM 06-38* (August 2006).
- 8 See *NTM 04-89* (December 2004). Other relevant *Notices* include *NTM 03-71* (November 2003) (relating to non-conventional instruments); *NTM 04-30* (April 2004) (relating to bonds and bond funds); *NTM 05-26* (April 2005) (relating to vetting new products); and *NTM 05-59* (September 2005) (relating to structured products).
- 9 IRS Section 72(t) permits penalty-free withdrawals from IRAs before the age of 59½ pursuant to a series of substantially equal periodic payments. Some registered representatives tout Section 72(t) as a "loophole" that allows investors to retire early by withdrawing assets and investing them in products or strategies that offer higher rates of return. In some cases, the registered representative may promise that the investments will generate returns high enough to allow the investor to maintain a standard of living that is equal to or even higher than they did while working. However, the promised rate of return may be unrealistically high, and investors may not fully appreciate the potential downside to such strategies, including the potential loss of their home, or the depletion of their retirement assets.
- 10 On December 27, 2006, the SEC published for comment proposed changes to Regulation D that would establish a new "accredited natural person" requirement for investments in "private investment vehicles." The new standard would exclude the equity in a primary residence from the calculation of an accredited natural person's investment assets. The Commission has not yet adopted the proposal. See Securities Act Release No. 8766 (December 27, 2006) (SEC File No. S7-25-06).
- 11 See Securities Act Release No. 8766 (December 27, 2006) (SEC File No. S7-25-06). See also Securities Act Release No. 8828 (August 3, 2007) (SEC File No. S7-18-07).

Endnotes (cont'd)

- 12 See NASD IM-2310-3, which outlines certain factors that may be relevant when considering compliance with Rule 2310(a) in connection with recommendations to institutional customers. Two important considerations in determining the scope of a firm's suitability obligations to institutional customers are the customer's ability to evaluate investment risk independently, and the extent to which the customer is exercising that ability in connection with the recommendation.
- 13 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.ndbf.org/forms/bd-ia-special-notice.pdf. The Massachusetts regulations became effective June 1, 2007. See 950 Mass. Code Regs. 12.204(2)(i) (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/sct/sctpropreg/propreg.htm. Further, as of the date of this Notice, the North American Securities Administrators Association, Inc. (NASAA) is developing a model rule that would "mak[e] it a separate violation of law to use a 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).
- 14 Firms that are aware of designations that are not included in FINRA's database are invited to provide us with the relevant information so that we may include them.
- 15 For relevant materials, visit the FINRA Investor Education Foundation's Web site, www.saveandinvest.org.

Endnotes (cont'd)

16 To better understand why older investors fall prey to investment fraud, the FINRA Investor Education Foundation funded researchers that analyzed undercover tapes of fraud pitches and surveyed victims and non-victims to determine how they differ. Some of the key research findings include:

- Investment fraud victims are more financially literate than non-victims;
- Investment fraud criminals use a wide array of different influence tactics—from friendship to fear and intimidation tactics—to defraud the victim;
- Fraud pitches are tailored to match the psychological needs of the victim;
- Investment fraud victims are more likely to listen to sales pitches;
- Investment fraud victims are more likely to rely on their own experience and knowledge when making investment decisions;
- Investment fraud victims experience more difficulties from negative life events than non-victims;
- Investment fraud victims are more optimistic about the future; and
- Investment fraud victims dramatically under-report fraud.

See Off the Hook Again: Understanding Why the Elderly Are Victimized by Economic Fraud Crimes, survey results and analysis prepared for WISE Senior Services by The Consumer Fraud Research Group (2006), available at www.finrafoundation.org/WISE_Investor_Fraud_Study_Final_Report.pdf.

©2007. FINRA. All rights reserved. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.