

Seniors – The Laws, The Rules, The Cases

By Richard Szuch and Brian J. Ellis

The recent economic downturn has taken its share of casualties. The market has soured, jobs have been lost, and nest eggs have cracked. Few, if any, investors have been immune to the current “great recession.” As a result, securities regulators are being called upon now more than ever to provide protection to displeased investors. In her testimony before the Senate Subcommittee on Financial Services and General Government, the new Securities and Exchange Commission (“SEC”) Chairperson Mary L. Schapiro reiterated the SEC’s commitment to “vigorous enforcement of the securities laws.”¹ According to Ms. Schapiro, since the end of January 2009, the SEC has filed at least 34 emergency temporary restraining orders, opened more than 358 investigations, and has issued at least 188 formal orders. These numbers represent significant increases compared to the same period of 2008.² Ms. Schapiro also noted the hiring of Robert Khuzami as the SEC’s new Director of Enforcement. Mr. Khuzami, a longtime federal prosecutor who served as Chief of the Southern District of New York’s Securities and Commodities Fraud Task Force testified recently before the U.S. Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment. Mr. Khuzami noted the need for increased funding to enable the Enforcement Division to meet today’s challenges.³ The need for additional Enforcement Division resources was also noted in the March 2009 report by the United States Government Accountability Office (“GAO”).⁴

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In these unprecedented times, not only are investors faced with a dismal economy, but investors are also confronted by complex investments, insurance/security hybrids, and confusing, sometimes contradictory information. As of late, professionals in the financial industry have had to maintain a delicate balance and keep a watchful eye to ensure compliance with federal, state, and Financial Industry Regulatory Authority (“FINRA”) laws, regulations, and rules. In this article, we provide a glimpse into recent regulatory enforcement actions involving some of the most vulnerable investors – seniors. Given the

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volatile state of the financial markets, fallout from the Bernard Madoff fraud, increased scrutiny on the roles and effectiveness of the various industry regulators, the near future should hold the possibility of significant regulatory changes. Indeed, new rules have already been approved with others waiting in the wings. In the current recession, investor protection is of paramount importance, and one can be certain that the protection of senior investors will continue to be a priority.

When we speak of senior investors, we define the group to include those at or near retirement, with assets that are or may be irreplaceable. Census data released in May 2008 shows that close to 38 million Americans are 65 years old or older, which accounts for thirteen percent of the population of the United States.⁵ FINRA Notice to Members (“NTM”) 07-43 states that number of Americans “at or nearing retirement age is growing at an unprecedented pace. By 2030, almost 1 out of every 5 Americans – approximately 72 million people – will be 65 years old or older.” Clearly, senior citizens form a large – and growing – segment of our society.

Legislation, Regulation and Enforcements

According to FINRA, there are no special rules for senior investors; however, age and life stage are important factors for firms to consider. In addition to NTM 07-43, there have been several recent initiatives aimed at protecting or advancing the rights of senior investors. The SEC, along with FINRA and the North American Securities Administrators Association (“NASAA”) held a second annual “Senior Summit” in September 2007 and issued a report that then-Commissioner Christopher Cox described as a “wake-up call for securities regulators, the financial services industry and especially older investors.”⁶

Currently, legislation is pending before federal and state legislatures, which provides enhanced protection against – and enhanced penalties for – securities violations involving senior investors. The “Senior Investment Protection Act of 2009”, S.906, sponsored by Senators Kohl and McCaskill, would provide grants to states for enhanced protection of seniors.⁷ These grants would be limited to states that have adopted “to the extent practicable” the NASAA Model Rule on professional designations. States may

use the grants to fund additional staff, technology, educational materials, and to enhance provisions of state law to protect seniors against misleading or fraudulent practices. Similarly, the “Senior Investor Protections Enhancement Act of 2008,” introduced by Senators Kohl and Casey, provides for additional penalties for violations against seniors. At the state level, there is also a growing movement to impose enhanced penalties for those who prey upon seniors.⁸ For example, legislation pending in Missouri, S.B. 91, modifies provisions of the state Securities Act to provide a minimum \$50,000 fine for persons convicted of criminal securities fraud against an elderly or disabled person and empowers the state commissioner of securities to impose enhanced penalties for securities fraud against the elderly or disabled.⁹

Having said this, apart from instances of outright fraud, review of recent state and regulatory enforcement actions has revealed little in the way of new developments regarding senior investors. FINRA recently barred a broker for converting and improperly using more than \$600,000 from the holdings of elderly customers. The broker deposited checks into his personal accounts and used the funds for his own benefit. According to Susan L. Merrill, FINRA Executive Vice President and Chief of Enforcement: “FINRA is committed to identifying and expelling anyone under our jurisdiction who preys on the trust and goodwill of his customers, particularly vulnerable customers like seniors.”

In another recently concluded action, a large broker-dealer was fined \$3 million and ordered to pay more than \$4.2 million in restitution to retirees to resolve charges that the firm’s supervisory system failed to detect and prevent brokers from persuading employees to take early retirement based upon unrealistic promises of consistently high investment returns and by espousing unsuitable investment strategies. Susan L. Merrill of FINRA stated: “Protecting investors who have retired or are considering retirement has been one of FINRA’s top priorities.” According to Ms. Merrill, “Brokerage firms and brokers who serve investors considering retirement must ensure that their customers are given suitable investment recommendations based upon reasonable assumptions of market performance and are given thorough disclosure of investment risks.”

Annuities

Registered persons and firms continue to face sanctions from both FINRA and state regulators for the improper sale of variable annuities to seniors. FINRA recently fined a large firm and ordered the firm to pay more than \$260,000 in restitution for a series of violations related to variable annuity sales and exchanges. Recent state enforcement actions have focused on situations where a high percentage of the senior investor's net worth has been placed into the annuity, as well as 1035 exchanges that detrimentally impact the senior investor (e.g., decreased death benefit, extended surrender period, etc.). According to Ms. Merrill: "Variable annuities are complex investments that are designed to be retirement savings vehicles and are meant for the long-term investor." FINRA has also stated that "marketing efforts used by some variable annuity sellers deserve scrutiny – especially when seniors are the targeted investors. . . . One scare tactic used with seniors is to claim that a variable annuity will protect them from lawsuits or seizures of their assets."

In a related vein, the SEC recently approved Rule 151, which applies to equity-indexed annuities issued on or after January 12, 2011.¹⁰ The new rule resolves the issue of whether equity-indexed annuities are insurance products or securities. The new rule provides that if the amounts payable by the insurer under the contract are more likely than not to exceed the amount guaranteed under the contract, the indexed annuity is not an insurance or annuity contract exempted by Section 3(a)(8) of the Securities Act. Thus, the equity-indexed annuity would be subject to the investor protections provided by the federal securities laws.¹¹ It is not now known whether state law and FINRA regulation will follow with their own law and regulation of these products, but given the abuses of the product, such regulation would be expected.

Viaticals

Regulators are also scrutinizing the sale to seniors of viatical settlements (also referred to as "life settlements" or "senior settlements") and "reverse mortgages." A viatical settlement involves the purchase by an investor of another person's life insurance policy. The policy is typically sold to the investor for

less than its face value, which provides the insured with immediate cash. When the insured dies, the investor collects the full face value of the policy.

According to an April 2009 Release by the NASAA, "[s]tate securities regulators continue to see problems of fraud and abuse in the growing life settlement industry."¹² Testifying recently before the U.S. Senate, NASAA President Fred Joseph, stated that "[l]ife settlements are complex financial arrangements, involving both securities and insurance transactions [R]egulating them effectively requires a joint effort by securities and insurance regulators, each applying their laws and expertise to different aspects of the product." In March 2009, the New York State Insurance Department proposed legislation regarding viatical settlements, stating that "[i]n these times of economic uncertainty, there is strong pressure on people pressed for cash to sell valuable assets, such as life insurance policies."¹³ The proposed legislation in New York would authorize the State Insurance Department to regulate licensing for life settlement providers and brokers. The proposed legislation would also require heightened disclosure of information concerning the viatical settlement contract. Further, the legislation would seek to establish safeguards against the unlawful release of information about the identity of an insured individual or policy owner without consent. FINRA is also reportedly considering the issuance of guidance related to viatical settlements.

Reverse Mortgages

Last year, FINRA issued an Investor Alert regarding "reverse mortgages."¹⁴ A "reverse mortgage" is a type of mortgage, sold only to individuals aged 60 years or older, in which a homeowner borrows against the value of his or her house. While interest does accrue, the borrower pays no interest during the life of the loan. The loan becomes due when the borrower dies, sells his or her home, or leaves the home for more than a year (e.g., to enter an elder care facility). Because interest accrues, at loan maturity the borrower is likely to owe more than what was borrowed. The amount owed may also be affected by declining home values or by the borrower living longer than expected.

According to the FINRA Investor Alert, reverse mortgages are expensive, with interest rates that

sometimes equal 4 percent to 8 percent of the loan value. Because borrowers still own the home, they remain responsible for taxes, insurance, and other costs. FINRA warns that if a borrower is “not able to meet these obligations, the lender may have the right to foreclose on your home, leaving you in the worst possible situation – no place to live, and no more home equity to draw on.”

Recently, regulators have been responding to deceptive practices with regard to reverse mortgages. For example, House Bill 2513, dealing with reverse mortgages, was recently proposed before the Arizona State House of Representative. H.B. 2513 would require, among other things, that loan originators receive certification from the homeowner that the homeowner has received financial counseling from an independent third party. The bill would also require that loan originators provide the homeowner with a statement and explanation of rights, obligations, and remedies at least ten days before closing. A loan originator’s failure to abide by these and other requirements would constitute consumer fraud.

Conclusion

Recently, there have been numerous enforcement actions against registered persons and firms who were less than careful in their sales of products, such as variable annuities, to senior investors. These firms have paid a hefty price in terms of monetary payments to aggrieved investors and regulators and have also suffered significant reputational damage. In light of the strained economy and difficulties facing investors, the near future appears to hold even more of the same. Bills pending before various federal and state legislatures, which target deceptive sales practices involving seniors, will only increase the scrutiny surrounding a registered person or firm when interacting with senior investors. A firm’s implementation and documentation of best practices with regard to senior investors will not only provide protection to its senior investor clients, but will also do a great deal to enhance the firm’s reputation with the senior community overall. Especially in the current uncertain economic environment, professionals and firms would do well to build, maintain and safeguard such a reputation.

ENDNOTES

¹ Mary L. Schapiro, Testimony Before the Subcommittee on Financial Services and General Government (June 2, 2009) (available at <http://www.sec.gov/news/testimony/2009/ts060209mls.htm>).

² Id.

³ Strengthening the SEC’s Vital Enforcement Responsibilities, Testimony of Robert Khuzami (May 7, 2009) (available at <http://banking.senate.gov>).

⁴ United States Government Accountability Office Report to Congressional Requesters, Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement (March 2009) (available at <http://www.gao.gov/new.items/d09358.pdf>).

⁵ U.S. Census Bureau News, Released May 1, 2008 (available at <http://www.census.gov/Press-Release/www/releases/archives/population/011910.html>).

⁶ “Free Lunch” Investment Seminar Examinations Uncover Widespread Problems, Perils for Older Investors (Sept. 10, 2007) (available at <http://www.sec.gov/news/press/2007/2007-179.htm>).

⁷ “Senior Investment Protection Act of 2009,” S.906 (available at <http://thomas.loc.gov/cgi-bin/query/z?c111:S.906.IS:>).

⁸ Several states have passed or amended securities laws and criminal statutes to impose “enhanced penalties” on people who commit financial crimes against seniors. See Jennifer Levitz, Laws Take On Financial Scams Against Seniors, Wall Street Journal D1 (May 19, 2009). These states include Arkansas, Idaho, Maryland, Michigan, Minnesota, Missouri, New Jersey, Rhode Island, and West Virginia. Id.

⁹ Current Bill Summary -- SB 91 (available at http://www.senate.mo.gov/09info/bts_web/Bill.aspx?SessionType=R&BillID=513340).

¹⁰ “Indexed Annuities And Certain Other Insurance Contracts,” 17 CFR Parts 230 and 240, Federal Register, Vol. 74n No. 11 (Jan. 16, 2009) (available at <http://www.sec.gov/rules/final/2009/33-8996fr.pdf>).

¹¹ On In January 2009, a lawsuit was filed in the U.S. Court of Appeals for the District of Columbia Circuit challenging new Rule 151.

¹² “State Securities Regulators Continue to See Fraud and Abuse in the Life Settlement Market,” (Apr. 29, 2009) (available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/10691.cfm).

¹³ “Legislation Proposed to Regulate Life Settlement Business,” New York State Insurance Department (Mar. 23, 2009) (available at <http://www.ins.state.ny.us/press/2009/p0903231.htm>).

¹⁴ FINRA Investor Alert, “Reverse Mortgages: Avoiding a Reversal of Fortune,” (Mar. 11, 2008) (available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/RetirementAccounts/P038113>).

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