2016 NASAA Broker-Dealer Coordinated Exam: **Summary of Preliminary Results**

September 2016

Introduction

NASAA is the voice of state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. The role of NASAA members in securities regulation is crucial as they serve as the first line of defense for investors from every walk of life. As part of their role on the front lines of emerging issues in securities regulation, NASAA and its members consider protecting senior investors a core part of their mission. With 10,000 Americans projected to turn 65 every day between now and 2030,[1] and in excess of 77 percent of all financial assets in the United States concentrated in the hands of those individuals,[2] NASAA and its members believe that protecting senior investors is essential. Indeed, according to one study, seniors lose $2.9 billion to financial exploitation every year.[3] Furthermore, in an environment of low interest rates, yet increasingly lengthy retirements, senior investors are facing the challenge of searching for higher yielding investment products, which often come with increased risk.

In the last decade, NASAA and its members have developed a number of initiatives aimed at protecting senior investors, from policy matters, to advocacy, and even regulatory actions. Policy initiatives by NASAA and its members have included a 2008 joint report with the SEC and FINRA on issues related to senior investors;[4] the drafting of a model rule addressing so-called "senior designations" and a model act to address the financial exploitation of vulnerable adults; the development of the Senior$afe Training program for financial professionals as well as the Serve Our Seniors website; and strong support for the Senior$afe Act of 2016 in the United States Congress. These initiatives have been in addition to the day-to-day work of

[1] *See* "Baby Boomers Retire," Pew Research Center, available at http://www.pewresearch.org/daily-number/baby-boomers-retire/.

[2] Securities Industry and Financial Markets Association, Senior Investor Protection White Paper: SIFMA and The Industry's Efforts to Protect Senior Investors, Apr. 27, 2016, available at http://www.sifma.org/issues/item.aspx?id=8589960115.

[3] The MetLife Study of Elder Financial Abuse, June 2011, available at www.metlife.com/assets/cao/mmi/publications/studies/2011/mmi-elder-financial-abuse.pdf.

[4] Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors (2008 Joint Report) (Sept. 22, 2008), available at https://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf.

NASAA members conducting examinations and initiating enforcement actions related to the exploitation of seniors and other vulnerable investors.

In 2016, NASAA members conducted a coordinated exam of broker-dealers ("Coordinated Exam") on issues related to senior investors. The Coordinated Exam sought information from the examined firms on policies, procedures, and training related to seniors and other potentially vulnerable customers. Twenty states sought information in several categories, including, among others:

- Proactive assessment efforts by the firms related to senior investors;
- Training provided by broker-dealers to employees regarding senior investors, the identification of elder abuse, and diminished capacity;
- Supervisory policies, procedures and other controls potentially relevant to senior investors; and
- Potential suitability concerns identified by member jurisdictions.

This report summarizes the preliminary findings as part of the ongoing dialogue between broker-dealers and NASAA members on the important issue of protecting senior investors.

COORDINATED EXAM HIGHLIGHTS:

- Approximately 20 percent of the exams involved a broker-dealer that has not established written supervisory procedures on **any** of the key senior issues focused on during the Coordinated Exam.
- The Coordinated Exam focused on three key senior investor related training topics. More than 62 percent of the exams related to a firm that offers training on **all** of these topics.
- There appears to be limited development of "trusted contact forms" at firms, and very limited use of the forms even after they are developed.
- Only 24 percent of the exams related to a brokerage that requires verification of senior clients' profile information more frequently than every 36 months.

- Potentially unsuitable recommendations to senior investors were identified in 10 percent of the exams.
- Firms permitting the use of "senior designations" may need to improve related controls and procedures.
- At most offices where *any* complaint had been filed in the 24-month period, the majority had been filed by senior clients.

Overview

The 2016 NASAA Coordinated Exam included 62 exams of broker-dealer offices during which the examination teams reviewed activity in senior client accounts. The Coordinated Exam primarily utilized a module designed for purposes of the Coordinated Exam. In addition to highlighting states' observations about broker-dealer practices, the Coordinated Exam was designed to identify possible relationships between supervision/training practices and sales related issues with senior clients. To that end, the exams collected information about each examined firm's policies and supervision practices along with transactional data.

The exams covered various broker-dealer models and office types. There were no mandates established with respect to the firms examined for the Coordinated Exam. Instead, each jurisdiction was encouraged to select the firms and offices examined in accordance with the jurisdiction's normal practices. This allowed for the jurisdictions to better account for qualitative and quantitative data and to maximize their ability to conduct relevant examinations.

The vast majority of the exams were conducted at branch or non-branch locations of broker-dealers while only a handful were identified as having been conducted at the firm's home office. Therefore, the data collected provides insight on the extent to which firms' policies and procedures related to senior investors have been implemented at remote locations.

At least 39 unique firms were examined during the Coordinated Exam. Some jurisdictions did not identify the name of the firm examined in accordance with jurisdictional requirements and practices. Consequently, these preliminary findings are being presented in terms of the number of exams conducted (i.e., X percent of the exams conducted indicated that the broker-dealer had a violation).

Committees or Personnel Dedicated to Senior Investor Issues

There are many complex and often sensitive issues that must be considered in order to better protect senior investors. Industry leaders have taken this charge very seriously, and many have created formal committees to develop useful practices and procedures. Some of the firms that have not created a senior investor-focused committee have at least designated one or more persons to address senior investor-related issues. Approximately 62 percent of the exams found that the broker-dealer had established a formal committee or designated at least one person to focus on senior investor issues.

Supervisory Procedures

Broker-dealers are required to establish and maintain supervisory systems and written procedures that are reasonably designed to ensure compliance with applicable securities laws.[5] Regulatory guidance has highlighted the importance of accounting for a firm's obligations to senior clients.[6] As a result, the Coordinated Exam assessed whether broker-dealers had developed written procedures specific to key concern areas and had incorporated enhanced controls into the firm's supervision of activity in senior client accounts.

The Coordinated Exam focused on whether the subject broker-dealer had implemented written procedures specific to four key issues:

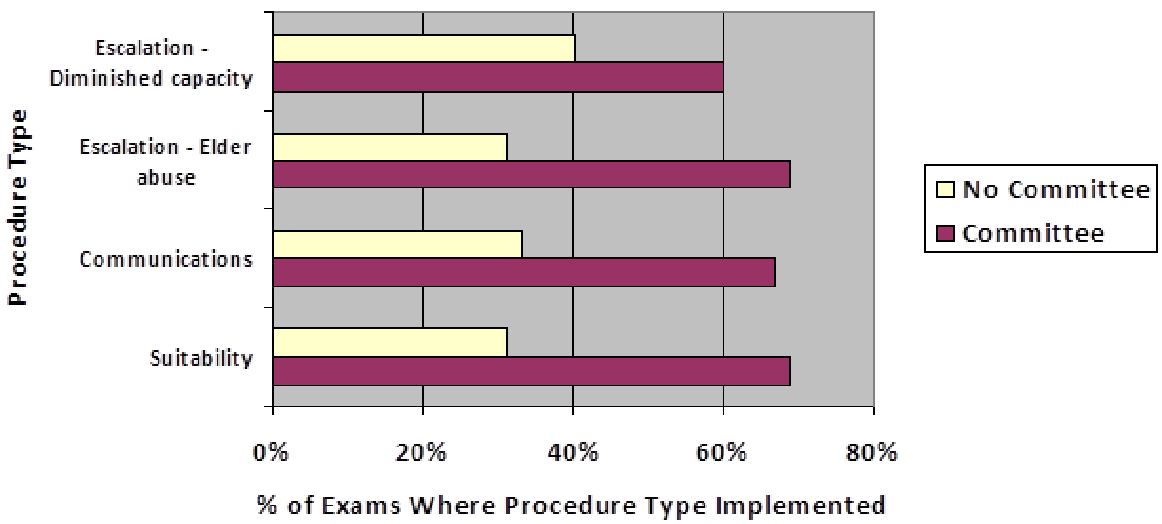
(1) The suitability of recommendations to senior investors;
(2) Communications with seniors;
(3) Escalation protocols in the case of suspected elder abuse; and
(4) Escalation practices in response to signs of diminished capacity.

[5] *See, e.g.* Uniform Securities Act § 204(a)(2)(J); *see also* FINRA Rule 3110.

[6] *See, e.g.* FINRA Regulatory Notice 07-43, September 2007, available at http://www.finra.org/sites/default/files/NoticeDocument/p036816.pdf.

About 39 percent of the exams resulted in findings that the brokerage had established written procedures addressing all four of these areas. On the other hand, 20 percent of the exams found that the brokerage had not established written procedures addressing *any* of the four areas.

As the chart below indicates, a firm with developed procedures on key areas related to senior investors is more likely to have designated a committee or personnel to focus on senior investors.



Training

There is some complexity and a great deal of sensitivity involved in identifying signs of elder abuse and diminished capacity. Similarly, the steps necessary to protect vulnerable seniors from various forms of intended and unintended harm can be equally complex. There are entire government agencies across the country dedicated solely to assisting senior citizens. Financial service professionals are not expected to be experts in this realm. However, they are well-positioned to serve as front-line defenders against the harm that elder abuse and diminished capacity may cause. Mandating participation in well-developed training will assist representatives and their firms in navigating those complexities and in protecting their senior clients.

The Coordinated Exam included an assessment as to whether examined firms currently provide training on communicating with seniors, escalating elder abuse and diminished capacity concerns, and suitability considerations for senior clients. Importantly, more than 62 percent of the exams found the firms offer training on all of these subjects. Moreover, virtually every firm that provides training on all three of the areas actually mandated that representatives take one or more of the trainings.

Communications with Senior Clients

Firms have recognized the need to take steps to improve their communications with senior clients. A 2008 report by NASAA, the SEC, and FINRA indicated that firms reported adopting practices such as increasing the frequency of contact with senior investors to stay on top of financial needs/life events and communicating in writing and documenting conversations with senior clients.[7] Such measures are essential to enhancing a firm's ability to prevent and mitigate the effects of elder abuse, but also toward recognizing signs of diminished capacity and supporting the recommendation of suitable investments by their representatives.

Trusted Contact Forms

One of the tools commonly discussed by financial service firms with respect to combatting the effects of elder abuse and diminished capacity is the "trusted contact form." Of course various names are used for this type of form, but the primary goal is the same. For purposes of the Coordinated Exam, a "trusted contact form" was defined as a form that captures the name and contact information of a trusted person that the firm may contact for purposes of administering

[7] 2008 Joint Report, *supra*, note 4 at 5.

the account or in the event of financial exploitation concerns.[8] Yet, only 39 percent of the exams indicated that the firm used some version of a trusted contact form.

To the extent this preliminary finding does not correspond with a broader impression of the use of trusted contact forms, this preliminary finding could indicate that awareness, and use, of trusted contact forms may be limited at certain branch locations.

In addition to asking if a firm has developed a form to collect trusted contact information, the Coordinated Exam also assessed how often the trusted contact information is actually collected. At firms where a trusted contact form was in use, less than 15 percent of all senior clients reviewed at those firms during the Coordinated Exam had a completed form.

There are various reasons why such information may not yet be on file. For example, a key factor could be whether or not the trusted contact form is only presented to a client at the time the account is opened or the client's profile is updated. The relatively recent implementation of trusted contact forms may also impact the current rate of use. More significant is the reality that many clients may hesitate to share such information, either out of concern about the privacy of the contact person or concern about allowing anyone else access to their own financial information. Financial service firms would be well advised to review their practices and communications related to trusted contact forms to maximize their ability to collect this information, especially from senior clients.

Frequency of Communications

There are many benefits to frequent communication with senior clients. In addition to serving client needs, frequent communications enhance the ability of representatives and brokerages to identify signs of diminished capacity or elder abuse. Moreover, frequent communications allow firms to update trusted contact information and key client profile information more

[8] Because such information may also be collected through other means, such as on new account opening forms, an affirmative response was required even is this type of information was collected on another form designed to collect additional information.

often. Some firms have long recognized the value of communicating more with senior clients.[9]

However, only 24 percent of the exams involved a firm that required verification of customer profiles of senior investors more often than the legal requirement of 36 months. Of course, it is possible that a firm verifies the profile information more often than every 36 months, but does not formally document more frequent verifications of senior clients' customer profile information. In any event, documentation of these verifications serves an important risk management purpose and may reflect the extent of a firm's investment in developing practices designed to protect its senior clients.

Other Communication Related Measures

The Coordinated Exam also sought to assess different ways that the brokerage industry has amended its communication methods with senior investors to account for common age-related changes in physical abilities, to identify/combat effects of elder abuse, and for general business risk management purposes. Firms examined during the Coordinated Exam have taken steps such as:

- Increasing the size of the font used in certain written communications;
- Documenting verbal communication more regularly; and
- Requiring meetings with senior clients to take place at the firm's office.

Suitability

An investor's age is obviously not the only factor to consider in a suitability analysis, but age can affect many of the other factors typically considered in a suitability analysis such as risk tolerance and investment objectives. Furthermore, senior investors who are retired face a greater challenge in overcoming the negative effects of an unsuitable recommendation that results in losses or a lack of sufficient liquidity.

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[9] *See* 2008 Joint Report, *supra*, note 4 at 5-8.

Procedures and Controls

Broker-dealers are required to review trading activity in all client accounts. The Coordinated Exam sought insight into whether brokerages would take the position that they did not need to establish procedures *specific* to suitability for senior investors. That is, do firms feel there is no need for specific procedures because age and life circumstances should be considered in connection with securities recommendations to most, if not all, individual clients.

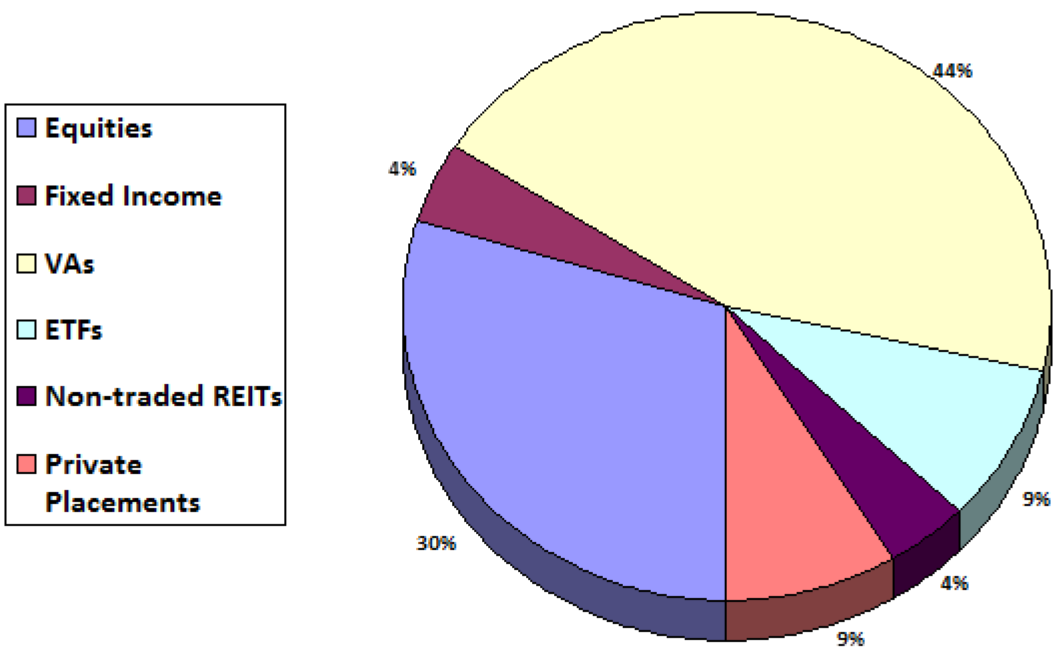
However, more than 72 percent of the exams found that firms had developed specific written procedures associated with suitability of recommendations to senior clients. Some firm responses suggested a view that suitability procedures specific to seniors were not necessary because of general suitability considerations. However, such a view appears to be in the minority.

Of the 45 exams where senior specific suitability procedures had been implemented, 21 involved a firm that mandated heightened reviews for the sale of certain investment products to seniors. Variable annuities and "alternative investments" were the primary product types for which firms mandated heightened reviews based on a specific age. Examples of alternative investments include, among others, investments in non-traded real estate investment trusts (REITs) and business development companies (BDCs). Examined firms utilize ages ranging from 55-80 as triggers for mandating heightened review before approving sales of selected products. One of the examined firms required heightened review before approving options activity for clients over the age of 70.

Broker-dealers are required to review trading activity in client accounts even in the absence of red flags. Interestingly, only 39 percent of all exams found that broker-dealers include clients' ages on the trade records used in connection with regular trade reviews. The inclusion of the age on trade review records could greatly improve a supervisor's ability to identify potentially unsuitable recommendations generally and specifically with respect to senior investors. Moreover, including the age on records reviewed by a supervisor would increase the number of firm personnel that might note suspect activity in an account that might indicate age-related diminished capacity or elder abuse.

Potentially Unsuitable Recommendations

Approximately 10 percent of the exams included in the Coordinated Exam identified potentially unsuitable recommendations to senior investors. The graph below is a breakdown of the frequency with which various products types were associated with the potentially unsuitable recommendations made to 41 senior clients included in the Coordinated Exam.



That variable annuities were the product most frequently associated with potentially unsuitable recommendations reinforces the importance placed on serving senior clients by state and federal securities regulators. In recent years, regulators have expressed concern about sales practices associated with variable annuities sales to senior investors.[10] In particular, there is a general concern with the sale of variable annuities to senior clients or those approaching retirement because of the penalty rates associated with early withdrawals.

Potential suitability issues were also identified with exchange-traded funds (ETFs) sold to seniors. The suitability concerns with ETFs primarily relate to non-traditional ETFs, such as leveraged and inverse ETFs. The "reset" periods associated with these products, which are often daily, can affect the suitability determination because the products are designed to achieve their objective within the reset period. Firms should closely monitor any sales of these products to senior investors given that these products are designed to be used as part of short-term trading strategies.

While traditional equities are not regularly discussed as priority concerns, regulators and the industry should note that 30 percent of suitability concerns identified during the Coordinated Exam involved equities. In fact, potential suitability issues related to equities far outweighed any identified concerns with other products that have received increased regulatory attention over the last few years such as non-traded REITs.

In the exams that evinced suitability concerns, there was no correlation with lack of training as the suitability concerns almost all occurred in exams of firms that actually *required* training on both senior investor suitability and communicating with seniors. Whether the potentially unsuitable recommendation was in fact unsuitable as well as whether the potentially unsuitable recommendations took place after the representatives participated in the mandatory training is beyond the scope of this report. Nonetheless, this finding should serve as a reminder to the industry that the mere existence of a training program, even a mandatory one, may not be enough if the training program is not adequately designed to effectively train representatives, if supervisors rely too heavily on the training, or if a firm ineffectively screens candidates at the hiring stage.

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[10] *See, e.g.* NASAA Informed Investor Alert: Annuities, available at http://www.nasaa.org/2692/informed-investor-alert-annuities/; *see also* FINRA Investor Alert: Variable Annuities Beyond the Hard Sell, available at https://www.finra.org/sites/default/files/InvestorDocument/p125846.pdf.

Marketing to Senior Investors

Through rulemaking and the issuance of industry-oriented guidance, financial service regulators have consistently stressed concern over potentially misleading marketing efforts related to senior investors.[11] Therefore, the Coordinated Exam reviewed common areas of concern to assess the prevalence of certain practices.

Seminars

Seminars targeting seniors, and especially "free lunch seminars," have been the subject of many investor alerts by state and federal regulators.[12] A report issued in 2007 by NASAA, the SEC, and FINRA concluded these seminars are designed to sell investments even though they are often touted as "educational;" attendees may not understand that the seminar is sponsored by a company tied to investments discussed at the seminar; and there were apparent weaknesses in firms' supervision of seminars.[13]

Thirteen of the offices examined had offered one or more investor-oriented seminars within the prior 12 months. Approximately 50 percent of these offices had offered seminars focused on senior investors or those approaching retirement. Importantly, these six exams resulted in no findings of concern by the examining jurisdiction. So, while concerns related to senior seminars still exist, the industry appears to have implemented improvements related to senior seminars.

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[11] *See, e.g.* NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations, available at http://www.nasaa.org/wp-content/uploads/2011/07/3-Senior_Model_Rule_Adopted.pdf.

[12] *See, e.g.* NASAA Investor Alert: Free Meal Seminars, available at, http://www.nasaa.org/1950/senior-investor-alert-free-meal-seminars/; *see also* FINRA Investor Alert: "Free Lunch" Investment Seminars—Avoiding the Heartburn of a Hard Sell, available at http://www.finra.org/investors/alerts/free-lunch-investment-seminars.

[13] Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars, (Sept. 2007), available at https://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

Senior Designations

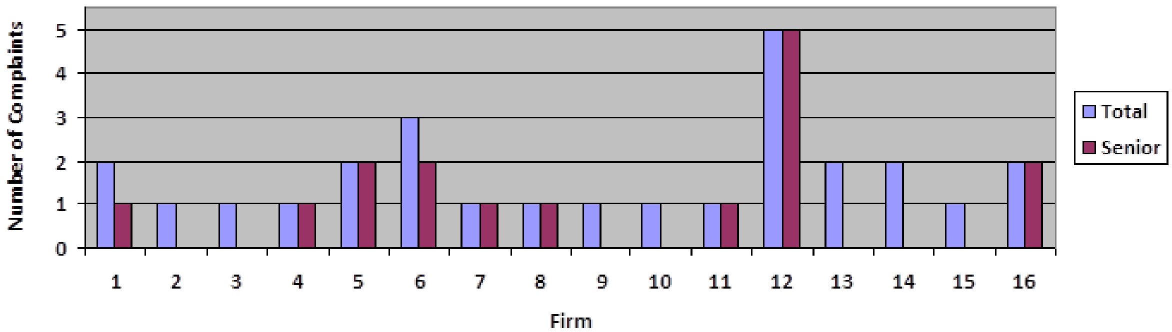
Approximately one-third of all exams involved a firm that permits representatives to use a "senior designation." For purposes of the Coordinated Exam, a senior designation was defined as any title or designation that conveys or suggests an expertise in senior investments or retirement planning. Of the firms that permit the use of senior designations, almost 48 percent of the exams were of firms that do not maintain a list of approved senior designations. Moreover, 25 percent of the exams where the broker-dealer allows the use of senior designations without a list of approved designations found that the firm did not even have procedures related to the approval of senior designations.

Thirty-two states have enacted rules designed to curb the use of designations that may mislead senior investors into believing that an individual has relevant expertise. These rules only permit the use of such designations when issued by a properly accredited entity to professionals who have completed an established training program and who are subject to reasonable monitoring and discipline for engaging in unethical conduct.

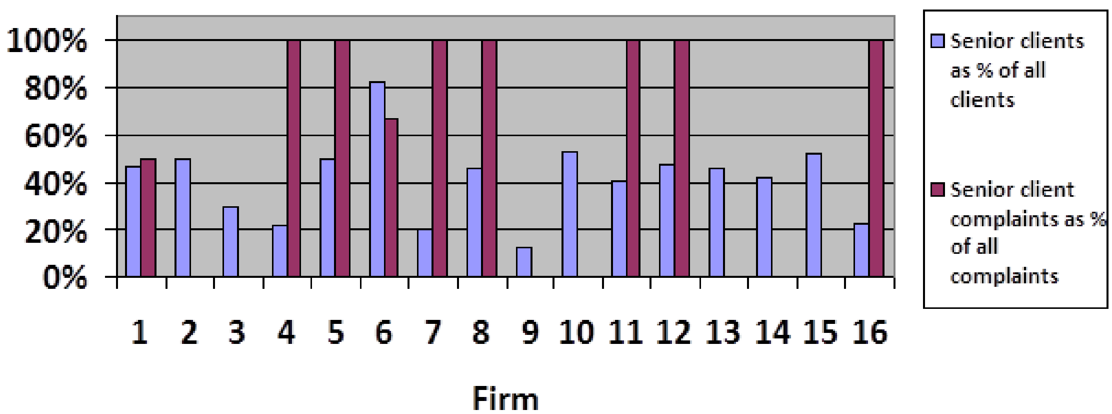
There are numerous designations used by financial service professionals that do not require sufficient, if any, demonstrated expertise or training on senior investor matters. Broker-dealers allowing the use of senior designations without appropriate controls and procedures are placing themselves and their senior clients at significant risk.

Complaints

While the focus of the Coordinated Exam was not enforcement-related, examiners observed an interesting trend in complaints that is worthy of mention. Examiners collected data on complaints related to the examined offices and filed within the prior 24 months. Overall, complaints filed by senior clients were found in approximately 15 percent of the offices examined.



More interesting is the fact that, over the relevant 24 month period at most offices where *any* complaint had been filed, the majority had been filed by senior clients.



Notably, in nearly 50 percent of offices with complaints, the relative frequency of senior client complaints was much higher than the percentage of the overall client base made up of senior clients. That is, the rate of complaints filed by senior clients is disproportionately high. Broker-dealers and regulators should continue their zealous efforts to effect change that will better educate financial service professionals and the investing public about suitability issues specific to senior investors.

Conclusion

NASAA and its members remain committed to advancing protections for senior investors. The Coordinated Exam is just one of the many efforts being undertaken currently by NASAA, the SEC, FINRA, and the industry. All of these efforts serve a shared objective—raising awareness of the issues affecting senior investors and fostering helpful changes in practices at firms and regulatory agencies.

The preliminary findings of the Coordinated Exam indicate that numerous broker-dealers are taking valuable steps such as designating personnel to focus on senior investor matters and developing procedures that are mindful of the common issues facing senior clients. Similarly, a majority of the exams involved a firm that has not only developed senior investor-specific training but has also mandated such training. It is also encouraging that examined broker-dealers are utilizing improved communication methods and are implementing age-related controls on certain investments.

However, these preliminary findings also identified areas where improvement appears needed. For example, it is concerning that 20 percent of the examinations involved firms that did not have written procedures on any of the areas previously highlighted by regulators. And while some firms are already using trusted contact forms, there is a need to enhance the methods and communications around collecting trusted contact information from senior clients to increase the rate at which such information is submitted. Senior investor complaints outpace the rate at which other clients filed complaints at the examined firms. In addition to the general relevance of this finding, it should serve to remind firms that improved communications with senior clients, and documentation of those communications, will not only serve these clients but will also serve an important risk-management purpose.

In sum, the preliminary findings from the Coordinated Exam indicate that past efforts to highlight senior investor matters have been successful at effecting change, but continued progress is necessary to best serve our aging population.