

# Financial Services

Providing Strategic Legal Guidance to the Global Financial Services Industry

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## FINRA Proposes Expansion of Safe Harbor in Cases of Suspected Financial Exploitation

Thwarting the financial exploitation of seniors and other vulnerable investors has been an increasing focus of several financial regulators in recent years, including the Financial Industry Regulatory Authority (“FINRA”). In 2017, FINRA adopted Rule 2165 (Financial Exploitation of Specified Adults) (“Rule 2165”) as a way for its member firms to respond when they reasonably suspect financial exploitation of vulnerable investors.<sup>1</sup> FINRA recently proposed two amendments to Rule 2165 and is currently requesting comments from the public through December 4, 2020.<sup>2</sup> One amendment would allow member firms to extend the permissible duration of holds on disbursements under certain circumstances, and the second would extend the safe harbor to cover securities transactions in addition to disbursements. In this alert, we briefly summarize the proposed amendments and offer suggestions for how firms might consider reacting to them.

### RULE 2165 AND THE PROPOSED AMENDMENTS

Rule 2165, which became effective in February 2018, provides a safe harbor for member firms when they exercise discretion in placing holds on disbursements of funds or securities when they suspect financial exploitation of retail investors who are (i) over the age of 65 or (ii) over the age of 18 with mental or physical impairments that render them unable to protect their own interests.<sup>3</sup> Rule 2165 allows firms to place a hold for up to 25 days on the disbursement of funds or securities when a firm “reasonably believes” that financial exploitation may be occurring.<sup>4</sup> The rule also generally requires firms, in addition to reasonably supervising and documenting their disbursement holds under the rule, to provide notice of the hold within two days to all persons authorized to transact business in the account and any identified “Trusted Contact Person” for the customer – unless any of these people are either unavailable or reasonably believed to be engaged in the suspected financial exploitation.<sup>5</sup>

FINRA’s first proposed amendment, if adopted and subsequently approved by the SEC, would expand the permissible use of holds for an *additional 30*



*business days* beyond the existing 25-day limit (for an overall 55-day limit), but only if the firm has reported or provided notification of its suspicions of financial exploitation to a state regulator or agency of competent jurisdiction or to a court of competent jurisdiction.<sup>6</sup> In a survey conducted by FINRA, 53% of respondents said they were unable to resolve matters within the current 25-day limit, with the most common reason being that the matter was still under consideration by a state agency or court.<sup>7</sup> Other reasons included the firm being unable to get a response from the customer, or the customer not believing that he or she was being financially exploited.<sup>8</sup> The same survey revealed that 59% of respondents took an average of 51-100 days to resolve these matters, which likely reflects the amount of time it takes for state agencies, such as a local adult protective service agency, or courts to resolve matters.<sup>9</sup>

FINRA's second proposed amendment would allow member firms to place holds not just on disbursements of cash or securities, but also on *transactions* in securities when the firm has a reasonable belief the customer is being financially exploited. FINRA justified this expansion on the ground that even if a suspicious disbursement from the account is thwarted, "executing a related transaction may result in significant financial consequences for the customer (e.g., tax consequences, surrender charges, the inability to regain access to a sold investment that has been closed to new investors)."<sup>10</sup> There are currently 31 states, representing approximately half the U.S. population, that allow investment advisers or broker-dealers to place some kind of temporary hold on securities transactions to prevent this type of exploitative activity. Further, in a FINRA survey, 25% of respondents reported that their customer agreements permitted placing transactional holds when exploitation was suspected.<sup>11</sup> The proposed amendment, if adopted and approved, would create for the first time a national standard for allowing member firms to place holds on securities transactions based on suspected financial exploitation.

#### LOOKING AHEAD

FINRA relies heavily on the expertise, knowledge, and experience of the industry and market participants to better understand how its rules are being implemented and their effectiveness in protecting investors and maintaining the integrity of the capital markets. As part of the rulemaking process, FINRA must file its proposed rules with the SEC and consider comments from member firms, investors, and the general public before rules are submitted for approval.<sup>12</sup> At times, depending on the types of comments received, the SEC may request that FINRA respond to the comments or make changes to the original rule proposal.<sup>13</sup> Particularly for newer rules like Rule 2165, FINRA may not have sufficient data to fully analyze the efficacy of the rule in protecting vulnerable investors. In these situations, firms are in a unique position to share their experiences with the rule's safe harbor, and to share alternative ideas or suggestions. Robust and detailed submissions from key industry players can directly assist FINRA in finalizing and submitting its proposed amendments to the SEC, which we expect will approve them, particularly in light of the Commission's current focus on protecting "Main Street" retail investors.<sup>14</sup>

FINRA also kept its rulemaking to a minimum here, which we believe leaves a good deal of room for firms to explore best practices in implementing the Rule and staying within the safe harbor. In FINRA's survey, only 52% of respondents said that they had procedures related to training in identifying red flags, documenting and escalating instances of diminished capacity, contacting trusted contacts or other authorized parties, and reporting matters to Adult Protective Services or law enforcement.<sup>15</sup> Firms might consider using the opportunity to build out internal procedures and supervisory controls governing the surveillance, detection, and investigation of suspected financial exploitation.

Whether Rule 2165 remains in its current form or is amended as contemplated, member firms should also consider regularly evaluating the effectiveness of their policies to protect against the financial exploitation of their most vulnerable customers. Member firms that often face these issues might even consider offering their observations and feedback to FINRA in the form of public comments, which are due by December 4, 2020.



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<sup>1</sup> <https://www.finra.org/rules-guidance/guidance/faqs/frequently-asked-questions-regarding-finra-rules-relating-financial-exploitation-seniors>; see also <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2165> (The term "financial exploitation" is defined in section (a)(4) of the Rule: "For purposes of this Rule, the term 'financial exploitation' means: (A) the wrongful or unauthorized taking, withholding, appropriation, or use of a Specified Adult's funds or securities; or (B) any act or omission by a person, including through the use of a power of attorney, guardianship, or any other authority regarding a Specified Adult, to: (i) obtain control, through deception, intimidation or undue influence, over the Specified Adult's money, assets or property; or (ii) convert the Specified Adult's money, assets or property.").

<sup>2</sup> <https://www.finra.org/rules-guidance/notices/20-34>.

<sup>3</sup> <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2165> ("For purposes of this Rule, the term 'Specified Adult' shall mean: (A) a natural person age 65 and older; or (B) a natural person age 18 and older who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests.").

<sup>4</sup> Pursuant to Rule 2165(b)(3), this initial hold of 15 business days can currently be extended for 10 business days, unless terminated or extended by a state regulator or agency or court of competent jurisdiction.

<sup>5</sup> <https://www.finra.org/rules-guidance/notices/17-11> ("For purposes of this Rule, the term "Trusted Contact Person" shall mean the person who may be contacted about the Specified Adult's Account in accordance with Rule 4512.").

<sup>6</sup> [https://www.finra.org/sites/default/files/2020-09/Regulatory\\_Note\\_20-34\\_Attachment\\_A.pdf](https://www.finra.org/sites/default/files/2020-09/Regulatory_Note_20-34_Attachment_A.pdf).

<sup>7</sup> <https://www.finra.org/rules-guidance/notices/20-34> ("The most common reason was that the matter was under consideration by a state agency (such as APS) or a court. Other common reasons included: (1) the customer did not respond to inquiries from the firm; or (2) the customer did not believe that he or she was being financially exploited.").

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> <https://www.finra.org/rules-guidance/notices/20-34>.

<sup>11</sup> <https://www.finra.org/rules-guidance/notices/20-34> ("During exams in 2019 focusing on Rule 2165, FINRA observed that some member firms included in their customer agreements the ability to place holds on transactions in securities, as well as disbursements of funds or securities, when financial exploitation is suspected. Approximately 25 percent of survey respondents indicated that their customer agreements currently permit placing temporary holds on transactions when financial exploitation is suspected.").

<sup>12</sup> See generally, <https://www.finra.org/rules-guidance/requests-for-comments>.

<sup>13</sup> See, <https://www.finra.org/rules-guidance/rulemaking-process>.

<sup>14</sup> <https://www.sec.gov/news/testimony/testimony-clayton-2019-12-10> (Remarks by SEC Chairman Jay Clayton – "Our first goal is to focus on the long-term interests of Main Street investors. This year we have continued to place a high priority on direct engagement with investors and other market participants."). The SEC has stepped up its focus on vulnerable populations of retail investors in recent years, including the population of adults covered by Rule 2165. For instance, the SEC has brought cases under "affinity fraud" which involve investment schemes targeting immigrants, churches, racial minorities, and members of particular workforces. See <https://www.sec.gov/spotlight/affinity-fraud.shtml>. In addition, the SEC has hosted numerous public meetings and informational roundtables with retail investors and established the Office of the Investor Advocate in 2014 to focus on educating and protecting retail investors, including seniors. See <https://www.sec.gov/page/investor-advocate-landing-page>. We should expect to see continued regulatory activity focusing on senior investors and other vulnerable communities from both the SEC and FINRA.

<sup>15</sup> <https://www.finra.org/rules-guidance/notices/20-34>.