Fiduciary Risk Management and Compliance Roundtable

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The information provided herein presents general information and should not be relied on as legal advice when analyzing and resolving a specific legal issue. If you have specific questions regarding a particular fact situation, please consult with competent legal counsel about the facts and laws that apply.
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Elder Abuse: New Developments

As discussed in the previous issue of the Fiduciary Monitor, last year the Financial Industry Regulatory Authority (FINRA) sought comment on proposed rule changes addressing the financial exploitation of seniors and other vulnerable adults.

FINRA is proposing: (1) amending FINRA Rule 4512 (Customer Account Information) to require financial institutions to make reasonable efforts to obtain the name of and contact information for a “trusted contact person” for a customer’s account; and (2) adopting new FINRA Rule 2165 (Financial Exploitation of Specified Adults), which would create a safe harbor for financial institutions exercising discretion to place temporary holds on the accounts of “specified adults” where the firm reasonably believes that financial exploitation has occurred, is occurring, has been attempted, or will be attempted. For the purposes of both the proposed amendment and new rule, FINRA defines a “specified adult” as “(A) a natural person age 65 and older; or (B) a natural person age 18 and older who the firm reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests.”

The industry and various constituents have begun to respond.

SEC Investor Advocate to Congress: ‘Appropriate Limits’ Needed in Elder Fraud Rules

The SEC’s Investor Advocate, Rick Fleming, told Congress that he will spend time this year watching the progress of proposed rules issued by FINRA and NASAA which would allow a broker-dealer or investment advisor to delay disbursement of funds if elder financial fraud is suspected.

While Fleming believes financial firms “should have the ability to pause disbursements of funds, contrary to the explicit instructions of a customer, if there is a reasonable belief that financial exploitation is occurring,” if the suspicion is
“strong enough to warrant a pause on a disbursement, it also should trigger an obligation to report the suspicious activity” to adult protective services (APS).

According to Fleming, any elder fraud rule or law “must balance two potentially conflicting goals: to respect every individual’s right to self-determination, and also to prevent his or her unwitting financial self-destruction. We should remove undue restraints that keep financial professionals from acting to protect their clients. Yet if we confer new authority on broker-dealers and investment advisors to intervene in clients’ accounts when they suspect elder exploitation, we must place appropriate limits on that authority.”

In 2010, Congress authorized $125 million to fight elder financial abuse when it passed the Elder Justice Act, but “the first actual appropriation came in 2015 and amounted to $4 million,” Fleming said. “Additional funding would go a long way toward helping APS address the financial exploitation of seniors, a problem that likely will grow in the coming years.”

Source:

As Elder Abuse Grows, Advisors Urged to Start Fighting It: SIFMA Forum

Kathleen Quinn, executive director of the National Adult Protective Services Association (NAPSA), suggests that financial advisors should help adult protective services get the funding that APS needs to address the growing elder financial abuse problem.

“[Financial Advisors] can much better make the case at the federal level that APS needs resources than APS itself,” said Quinn. “We need more resources, we absolutely need more resources . . . . The financial services industry needs APS because clients being abused usually very often have multiple issues going on that need to be addressed and we’re the people charged with doing that,” said Quinn.
Quinn also noted that the Gramm-Leach-Bliley Act, which replaced Glass-Steagall, allows financial institutions to comply with civil investigations APS conducts in order to protect and prevent fraud.

**Source:**


**Calls to FINRA Senior Helpline Uncover Emerging Scams**

Since launching its Securities Helpline for Seniors in April, FINRA said it has received more than 2,500 calls and helped senior investors recover close to $750,000 in voluntary disbursements from FINRA member firms. FINRA reports that the average phone call on its Helpline for Seniors lasts an average of 25 minutes!

Most of the calls came from Florida, California, and New York.

FINRA also refers matters that fall outside its jurisdiction to federal and state agencies. As of December 30, 2015, FINRA made over 75 referrals since the Helpline’s launch.

The toll-free helpline is staffed by FINRA employees. For non-investment questions, the staff frequently refers callers to AARP.

**Source:**

Summary of Public Comments on FINRA’s Proposed Rules Relating to Financial Exploitation of Seniors and Other Vulnerable Adults

- The proposed rules should include language expressly allowing FINRA member firms to voluntarily report suspected cases of financial exploitation to state securities regulators, adult protective service organizations, or other law enforcement officers in cases of suspected financial exploitation.

- FINRA should provide template language that member firms can use in account applications or stand-alone forms to obtain the trusted contact’s information and requisite consent to notify the trusted contact if the firm believes financial exploitation of the account owner has occurred, is occurring, has been attempted, or will be attempted.

- Advisers who have direct contact with the account holders should be given training to allow the advisors to identify red flags such as drastic changes in the management of an account, changes in an individual’s appearance, and increased reliance on another individual.

- FINRA should require that brokers identify not just one trusted contact person, but also a second trusted contact person in case the first is unavailable.

* These representative comments are intended to provide a short summary of the most common public suggestions and comments to the proposed rules. Among the organizations submitting during the public comment period were SIFMA, NAPSA, ICI, Commonwealth Financial Network, NAELA, FSR, PIABA, NASAA, AARP, Wells Fargo Advisors, LLC, and the Alzheimer’s Association.
FINRA should consider adding a layer of consumer protection by requiring the broker and qualified individual to act with “reasonable care.” Requiring reasonable care in determining that financial exploitation appears to be occurring, is likely to occur, or has occurred would regulate how the broker and qualified individual treat their client during the hold period.

FINRA should require firms to notify individuals in writing when they are named as trusted contacts and when their designation changes because account holders have named new trusted contacts. Currently, the proposed amendment makes the underlying assumption that a trusted contact will engage in conversation with a firm and will willingly confirm personal details about the firm’s customers. However, many individuals who are unaware of their status as a named trusted contact likely will find it concerning when a stranger contacts them about someone they know and asks about personal details like the customer’s contact information, health status, and any existing legal representation.

“A member firm should be required to place a temporary hold in order to prevent or mitigate the dissipation of its client’s assets. As written, the proposed rule would allow a broker-dealer to ignore evidence of financial exploitation of a vulnerable adult because the rule is permissive.”

A member firm should be required to place a temporary hold in order to prevent or mitigate the dissipation of client’s assets. As written, the proposed rule would allow a broker-dealer to ignore evidence of financial exploitation of a vulnerable adult because the rule is permissive. If a broker-dealer or registered person becomes aware of information sufficient to establish a reasonable belief of financial exploitation of a vulnerable adult, it does not have to place a temporary hold on the disbursement of funds or securities.
• As written, a “senior” is defined as a person sixty-five or older. However, the Elder Justice Act, the Older Americans Act, and states like Missouri and Washington have defined a “senior” as a person sixty or older. (NASAA also recently put forth a proposed model act defining “eligible adults” to mean “a person sixty years of age or older.”). The proposed rules should follow the definition used by the federal government, various states, and NASAA, which will eliminate conflicting regulatory definitions and reduce confusion for member firms.

• FINRA should include additional language in the proposed rules specifically excluding accounts where there is a designated Guardianship, Custodian, or Power of Attorney appointed. These protections should be offered to firms above and beyond any safe harbor since there is greater concern with someone having account transaction authority as compared to a trusted emergency contact that does not have authorization on the accounts.

• Currently, the only type of situation FINRA defined for the purposes of this rule is “financial exploitation.” FINRA also should include “suspected diminished capacity” so firms are encouraged to apply this rule if a customer is making poor financial decisions due to cognitive impairment.

• The proposed rules should allow account owners a separate right of recourse (aside from obtaining a court order) in the event of a freeze. This would help assuage civil liability concerns arising out of an inappropriate account freeze by providing account owners an alternative means to address their concerns— including the ability to recoup any damages caused by such freeze—without resort to a civil suit.

On January 22, 2016, NASAA members voted to adopt the Model Act. The Act mandates reporting to a state securities regulator and state adult protective services agency when a qualified individual has a reasonable belief that financial exploitation of an eligible adult has been attempted or has occurred. The Act’s mandatory reporting obligations—cushioned by express immunity provisions—are designed to create incentives to encourage broker-dealers and investment advisers to report potential financial exploitation as early as possible, when their intervention may be able to prevent harm or limit the damage to victims of financial exploitation.

Application

“Eligible adults” includes those age 65 or older and those adults who would be subject to the provisions of a state’s adult protective services statute. “Qualified individuals” include broker-dealer agents, investment adviser representatives, those who serve in a supervisory, compliance, or legal capacity for broker-dealers and investment advisers, and any independent contractors that may be fulfilling any of those roles.

Key Provisions:

- **Mandatory Reporting.** The Act mandates reporting to the state securities regulator and state adult protective services agency when a qualified individual has a reasonable belief that financial exploitation of an eligible adult has been attempted or has occurred.

- **Notification.** The Act authorizes notification to third parties only in instances where an eligible adult has previously designated the third party to whom the disclosure may be made. Disclosures may not be made to...
the third party if the qualified individual suspects the third party of the financial exploitation.

- **Delayed Disbursements.** The Act enables broker-dealers or investment advisers to impose an initial delay of disbursements from an account of an eligible adult for up to 15 business days if financial exploitation is suspected. The delay can be extended for an additional 10 days at the request of either the state securities regulator or adult protective services.

- **Immun**ity. The Act provides immunity from administrative or civil liability for broker-dealers and investment advisers for taking actions including delaying disbursements as permitted under the Act.

- **Records.** The Act requires qualified individuals to provide records that are relevant to the suspected or attempted financial exploitation to government authorities.

**Next Steps**

The Model Act currently is available to NASAA members for consideration in their jurisdictions. The Act may be adopted as legislation during state legislative sessions or implemented by regulation. Whether adoption is by legislation or regulation depends on individual jurisdictions. Jurisdictions considering the Act as legislation or regulation also may need to consider certain small changes to terms.

At the time of printing these materials, Vermont appears to be the only state to propose new rules based on the adopted model rules (http://wealthmanagement.com/blog/vermont-beefs-cyber-elder-abuse-safeguards). Some states, including Indiana and Nebraska, had already introduced similar bills this year (http://www.famag.com/news/state-regulators-propose-mandate-for-supervisors-to-report-elder-abuse-24952.html), and others, like Washington, Delaware, and Missouri, already had them in the books (http://www.sifma.org/newsroom/2015/sifma_commends_missouri_s__senior_savings_protection_act_/).
Fiduciary Regulatory Updates

The DOL’s New Fiduciary Rule: “Conflict of Interest Rule—Investment Advice”

ERISA provides the DOL with authority to create rules designed to protect America’s tax-preferred retirement savings. The DOL has proposed new rules (announced on April 20, 2015), seeking to expand the types of retirement investment advice covered by fiduciary standards. Defining the scope of investment advice is important because, under a fiduciary standard, an adviser must provide investment advice in the best interests of plan participants.

Current Standards

To fall within ERISA’s existing fiduciary standards, an individual providing investment advice must:

1) make recommendations on investing in, purchasing, or selling securities, or give advice as to the value
2) on a regular basis
3) pursuant to a mutual understanding that the advice
4) will serve as a primary basis for investment decisions, and
5) will be individualized to the particular needs of the plan.

By proposing to expand the type of investment advice covered by fiduciary protections, the DOL’s proposed rules would have fiduciary standards to apply to activities that currently occur within pension and retirement plans but have no historically created a fiduciary duty.

Proposed Standards

As proposed, a fiduciary standard would apply to any individual receiving compensation for providing advice that is individualized or specifically directed to a particular plan sponsor (e.g., an employer with a retirement plan), plan participant, or IRA owner for consideration in making a retirement
**decision.** The proposals do not require that advice be provided on “a regular basis,” and would include one-off or “isolated” decisions such as what assets to purchase or sell and whether to rollover from an employer-based plan to an IRA. The fiduciary can be a broker, registered investment adviser, insurance agent, or other type of adviser.

**Carve-Outs Proposed**

- **Maintaining access to retirement education.** Education is not included in the definition of retirement investment advice so that advisers and plan sponsors can continue to provide general education on retirement saving across employment-based plans and IRAs without triggering fiduciary duties. As an example, education could consist of general information about the mix of assets (e.g., stocks and bonds) an average person should have based on their age, income, and other circumstances, while avoiding suggesting specific stocks, bonds, or funds that should constitute that mix. This carve-out is similar to previously issued guidance to minimize the compliance burden on firms, but clarifies that references to specific investments would constitute advice subject to a fiduciary duty.

- **Distinguishing “order-taking” as a non-fiduciary activity.** As under the current rules, when a customer calls a broker and tells the broker exactly what to buy or sell without asking for advice, that transaction does not constitute investment advice. In such circumstances, the broker has no fiduciary responsibility to the client.

- **Sales pitches to plan fiduciaries with financial expertise.** Many large employer-based plans are managed by financial experts who are themselves fiduciaries and work with brokers or other advisers to purchase assets or construct a portfolio of investments that the plan offers to plan participants. In such circumstances, the plan fiduciary is under a duty to look out for the participants’ best interest and understands that if a broker promotes a product, the broker may be trying to sell them something rather than provide advice in their best interest. Accordingly, the proposed rule does not consider such transactions fiduciary investment advice if certain conditions are met.
How is Compliance Achieved: The Proposed “Best Interest Contract” (BIC) Exemption

Under ERISA and the Internal Revenue Code, individuals providing fiduciary investment advice to plan sponsors, plan participants, and IRA owners are not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption (PTE). The proposed rules create a new type of PTE that is claimed to be broad, principles-based, and adaptable to changing business practices. The proposed BIC exemption is designed to allow firms to continue setting their own compensation practices if they, among other things, commit to putting their client’s best interest first and disclosing any conflicts that may prevent the firms from doing so. Commons forms of compensation used in the financial services industry today, such as commissions and revenue sharing, will be permitted under this exemption, whether paid by the client or a third party such as a mutual fund.

To qualify for the new BIC exemption, the company and individual adviser providing retirement investment advice must enter into a contract with clients that:

- **Commits the firm and adviser to providing advice in the client’s best interest.** Committing to a best interest standard requires the adviser and the company to act with the care, skill, prudence, and diligence that a prudent person would exercise based on the current circumstances. In addition, both the firm and the adviser must avoid misleading statements about fees and conflicts of interest. These are claimed to be well-established standards in the law, simplifying compliance.

- **Warrants that the firm has adopted policies and procedures designed to mitigate conflicts of interest.** Specifically, the firm must warrant that it has identified material conflicts of interest and compensation structures that would encourage individual advisers to make recommendations that are not in clients’ best interests and that it has adopted measures to mitigate any harmful impact on savers from those conflicts of interest. Under the exemption, advisers will be able to continue receiving common types of compensation.
- Clearly and prominently discloses any conflicts of interest, like hidden fees often buried in the fine print or backdoor payments, that might prevent the adviser from providing advice in the client’s best interest. The contract also must direct the customer to a webpage disclosing the compensation arrangements entered into by the adviser and firm and make customers aware of their right to complete information on the fees charged.

In addition to the new BIC exemption, the proposal sets forth a new, principles-based exemption for principal transactions and maintains or revises many existing administrative exemptions. The principal transactions exemption would allow advisers to recommend certain fixed-income securities and sell them to the investor directly from the adviser’s own inventory, as long as the adviser adhered to the exemption’s consumer-protective conditions.

How close are we to final rules?

As of January 29, 2015, the DOL’s proposed rules are before the Office of Management and Budget (OMB) for the OMB’s mandatory review. After release of the final rule, Congress has 60 days to adopt a joint resolution of disapproval (if it opposes the regulation), and thereafter the President could veto Congress’ resolution. Other legislation, designed to stop progress on DOL’s rules until after the SEC writes its own fiduciary rule, also remains pending.

Sources:


Proposed Rules by New York’s Department of Financial Services Superintendent’s Regulations

Banking Division Transaction Monitoring and Filtering Programs Requirements and Certifications

New York’s Department of Financial Services (the “Department”), which regulates some of the world’s largest banks, has proposed rules that would require compliance officers to certify bank systems for monitoring suspicious transactions that violate U.S. economic sanctions and other rules. Senior officers who file incorrect or false annual certifications could be criminally prosecuted. The proposed rules go further than others, arguably giving the agency more leeway to pursue money-laundering cases than federal banking regulators.

The Department reports that it has recently been involved in a number of investigations into compliance by Regulated Institutions with applicable Bank Secrecy Act/Anti-Money Laundering laws and regulations (BSA/AML) and Office of Foreign Assets Control (OFAC) requirements implementing federal economic and trade sanctions.

As a result of these investigations, the Department claims it has become aware of the shortcomings in the transaction monitoring and filtering programs of these institutions and that a lack of robust governance, oversight, and accountability at senior levels has contributed to these shortcomings. The Department believes that other financial institutions may also have shortcomings in their programs for
monitoring transactions for suspicious activities, and watch-list-filtering programs, for “real-time” interdiction or stopping of transactions on the basis of watch lists, including OFAC or other sanctions lists, politically exposed persons lists, and internal watch lists.

To address these deficiencies, the Department is seeking to clarify the required attributes of a transaction monitoring and filtering program and to require a certifying senior officer of regulated institutions to file annual certifications regarding compliance by their institutions with the standards promulgated by the Department.

“Regulated Institutions” is defined as “all Bank Regulated Institutions and all Nonbank Regulated Institutions.” And “Bank Regulated Institutions” is defined as “all banks, trust companies, private bankers, savings banks, and savings and loan associations chartered pursuant to the New York Banking Law (the “Banking Law”) and all branches and agencies of foreign banking corporations licensed pursuant to the Banking Law to conduct banking operations in New York.” “Nonbank Regulated Institutions” is defined as “all check cashers and money transmitters licensed pursuant to Banking Law.”

Source:

New and Noteworthy: Litigation/Forensic Considerations

Amended Federal Rules of Civil Procedure

Several changes to the Federal Rules went into effect on December 1, 2015. Perhaps the most talked about, and most likely to impact civil litigation on a daily basis, are the changes regarding the scope of permissible discovery in Rule 26 and spoliation of electronically stored information in Rule 37.

The “New” Proportionality Standard

Rule 26(b) sets forth the scope and limits of permissible discovery. The former version of the Rule allowed parties to discover information “reasonably calculated to lead to the discovery of admissible information.” The “reasonably calculated” language has been cut from the new Rule.

Now, under the new Rule, a party is entitled to discovery that is relevant to the claims and defenses and “proportional to the needs of the case.” Proportionality is determined by consideration of six different factors, including the importance of the issues at stake, the parties’ resources, and the parties’ access to the information sought.

The concept that requested discovery should be proportional to the needs of the case is not new; the prior version set forth similar proportionality factors in a different section of Rule 26. Still, some view the change as ushering in a new standard. New standard or not, the amendment certainly makes the focus on proportionality more prominent. In practice, lawyers used “reasonably calculated” to gain access to documents, rather than sizing up expense or burden. Whether the enhanced focus on proportionality will have the effect of narrowing the access to discovery and reducing costs remains to be seen.
(b) Discovery Scope and Limits.

(1) **Scope in General.** Unless otherwise limited by court order, the scope of discovery is as follows: Parties may obtain discovery regarding any nonprivileged matter that is relevant to any party’s claim or defense and proportional to the needs of the case, considering the importance of the issues at stake in the action, the amount in controversy, the parties’ relative access to relevant information, the parties’ resources, the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit. Information within this scope of discovery need not be admissible in evidence to be discoverable. —including the existence, description, nature, custody, condition, and location of any documents or other tangible things and the identity and location of persons who know of any discoverable matter. For good cause, the court may order discovery of any matter relevant to the subject matter involved in the action. Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible evidence. All discovery is subject to the limitations imposed by Rule 26(b)(2)(C).

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(2) **Limitations on Frequency and Extent.**

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(C) **When Required.** On motion or on its own, the court must limit the frequency or extent of discovery otherwise allowed by these rules or by local rule if it determines that:

(i) the discovery sought is unreasonably cumulative or duplicative, or can be obtained from some other source that is more convenient, less burdensome, or less expensive;

(ii) the party seeking discovery has had ample opportunity to obtain the information by discovery in the action; or

(iii) the burden or expense of proposed discovery is outside the scope permitted by Rule 26(b)(1) outweighs its likely benefit, considering the needs of the case, the amount in controversy, the parties’ resources, the importance of the issues at stake in the action, and the importance of the discovery in resolving the issue.
Uniform, 4-Part Test for Sanctioning Failure to Preserve Electronically Stored Information

Rule 37 previously provided that, absent exceptional circumstances, a court could not impose sanctions on a party for failing to provide electronically stored information ("ESI") lost as a result of the routine, good faith operation of an electronic information system. Now the Rule provides a 4-part test.

Under the new standard, a court may order sanctions where (1) the ESI should have been preserved; (2) the party failed to take reasonable steps to preserve it; (3) it cannot be restored or replaced through additional discovery; and (4) either the party seeking the ESI is prejudiced by the loss or the party who failed to preserve the ESI acted intentionally to deprive the other party of the information.

Upon a finding of prejudice to the requesting party, the court may order measures no greater than necessary to cure the prejudice. Upon a finding of intent to deprive, the court or jury may presume that the lost information was unfavorable to the party or the court may dismiss the action or enter a default judgment.

According to the Committee Notes, the change reflects recognition that “perfection in preserving all relevant [ESI] is often impossible” and parties do not always maintain control of information that is stored in the cloud or subject to cyber-attack. The changes reject some courts’ imposition of severe sanctions upon a finding of negligent or grossly negligent behavior and instead limit severe sanctions to circumstances involving intentional loss or destruction.
Redline of Changes to Rule 37(a), and (e)

(a) **Motion for an Order Compelling Disclosure or Discovery.**

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(3) **Specific Motions.**

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(B) **To Compel a Discovery Response.** A party seeking discovery may move for an order compelling an answer, designation, production, or inspection. This motion may be made if:

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(iv) a party fails to produce documents or fails to respond that inspection will be permitted—or fails to permit inspection—as requested under Rule 34.

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(e) **Failure to Provide Preserve Electronically Stored Information.** Absent exceptional circumstances, a court may not impose sanctions under these rules on a party for failing to provide electronically stored information lost as a result of the routine, good-faith operation of an electronic information system. If electronically stored information that should have been preserved in the anticipation or conduct of litigation is lost because a party failed to take reasonable steps to preserve it, and it cannot be restored or replaced through additional discovery, the court:

(1) upon finding prejudice to another party from loss of the information, may order measures no greater than necessary to cure the prejudice; or

(2) only upon finding that the party acted with the intent to deprive another party of the information’s use in the litigation may:

(A) presume that the lost information was unfavorable to the party;

(B) instruct the jury that it may or must presume the information was unfavorable to the party; or

(C) dismiss the action or enter a default judgment.
Binding Electronic Signatures: Leveraging Technology in High-Risk Online Transactions

Adapted from Reggie Davis & Ieuan G. Mahony, Practicing Law Institute (Jan. 25, 2016).

Roadmap

- The “Vision”
- U.S. Legal Requirements
- Key Concepts
  - Case Law Examples
  - Challenges in High-Risk Transactions
- Technical Solutions
- Implementation: Risk Assessment

Basic Electronic Signature

- No third party authentication required
- Any electronic sound, symbol, or process attached to or logically associated with a record and executed by a person with the intent to sign the record
- E.g., the “Accept” or “I agree”, signing on an electronic signature pad, typing one’s name on a signature line, or applying a digital signature image

Digital Signature

- Authenticates the identity of the signer and sometimes the integrity of the signed document
- Uses public key cryptography and a digital certificate
- Sometimes referred to as “advanced electronic signatures” or “qualified electronic signatures” outside the US

Source: Reggie Davis & Ieuan G. Mahony, Binding Electronic Signatures: Leveraging Technology in High-Risk Online Transactions, PRACTICING LAW INSTITUTE, (Jan. 25, 2016) (presentation to be distributed with digital version of this issue).
Fiduciary Case Law Update

_In re Sentinel Mgmt. Grp., Inc., 809 F.3d 958, 962 (7th Cir. 2016)_

**Conduct and Claims:**

Sentinel was a cash management firm that invested cash, lent it by its customers, in liquid low-risk securities. Sentinel also traded on its own account, using money it borrowed from two banks to finance the trades. One of the banks required that its loans be secured by its borrowers, of whom Sentinel was one. However, not owning enough assets to provide the required security, Sentinel pledged securities that it had bought for its customers with their customers’ own money, in violation of federal law and Sentinel’s contracts with its customers.

In 2011, Sentinel filed for Chapter 11 bankruptcy, and the banks asserted a claim in the amount of $312 million. In response to the banks’ claims, the Trustee of the Chapter 11 estate urged the district court to find that the transfer of the customers’ securities to the banks was fraudulent and therefore voidable under the bankruptcy laws.

**Reasoning and Result:**

Explaining the difference between actual notice and inquiry notice, the court explained that the bank would have been in the clear had it accepted pledged assets in “good faith,” but that the bank would not have been acting in good faith if it had “inquiry notice.” Thus, the question was whether the banks had knowledge that would lead a reasonable, law-abiding person to inquire further. Did the banks have knowledge that would make a reasonable person “suspicious enough to conduct a diligent search for possible dirt[?]”

A key internal note from the bank proved pivotal. In the note, a bank managing director questioned how Sentinel could post over $300 million in collateral given that it had less than $20 million in capital, and asked whether Sentinel had rights to the entire $300 million pledged. (In fact, Sentinel’s capital was less than $3 million). Even standing alone, this suspicion was enough to put the banks on inquiry notice since “all that is required to trigger [inquiry notice] is information that would cause a reasonable person to be suspicious enough to investigate.” Because the banks had failed to investigate, the court voided the banks’ liens as fraudulent transfers, therefore leaving the banks with unsecured claims.

However, the Seventh Circuit declined to “equitably subordinate” the banks’ claims because the banks merely suspected wrongdoing—this was negligent but not so “serious,” “egregious,” or “tantamount to fraud” as to permit a bankruptcy court to reduce the priority of the claims.

**Why this case is notable:**

This decision should remind banks that they have affirmative obligations to investigate transactions when they are alerted to possible red flags. An obligation to make an affirmative inquiry arises when one knows of facts calling into question the legitimacy of a transaction, including the pledge of collateral. This is a low threshold: only that a reasonable person would be suspicious enough to investigate further.
Conduct and Claims:

Bernerd Young was the former District Director of NASD’s Dallas office and later the Chief Compliance Officer at Stanford Group Company Inc. at the time the now-defunct Stanford’s $7 billion Ponzi scheme fraud was exposed. Allen Stanford, the principal in the fraud, was eventually sentenced to 110 years in prison. An initial decision by a SEC Administrative Law Judge, in 2013, barred Young from the industry and ordered him to pay more than $850,000 in penalties and disgorgement after allegedly turning a blind eye to signs of Stanford’s scheme. Significantly, the SEC’s case against Young did not allege that he actually knew of the scheme; instead, it turned on whether the former compliance officer sufficiently ensured that marketing materials and other disclosures were adequate for advisors. The initial decision noted that Young ignored numerous “red flags” about the true nature of the business. For example, when a clearing broker notified the company that it would no longer process wire transfers because of the lack of transparency in the portfolio, the management sent an e-mail (which Young was copied on) that it was due to a tax reporting issue. Clients also questioned the legitimacy of an Antiguan “non-big four” auditing company (the court acknowledged the “climate of corruption” there) reviewing the books. They further requested to know what other companies the auditor had reviewed, to which the company responded that the information “is not public.”

Arguments on Appeal:

On February 8, 2016, the SEC heard oral argument in this appeal. Young has maintained throughout the case, and he continues to argue on appeal, that he should not be held liable because, among other things, he relied on attorneys and other officials both inside and outside the Stanford firm throughout the relevant period. In fact, two of the individuals Young relied on were later found to have been bribed for their role in the scheme. Moreover, from a compliance standpoint, Young argues, he should not be held liable for his purported failure to review training and marketing materials because this had nothing to do with the sale of securities. Young states that some of these materials were actually in use by Stanford more than 12 months prior to Young even joining the company.

Young also points to the fact that Stanford had been the subject of five previous NASD/FINRA examinations, two SEC examinations, and at least two examinations of the state security board of Texas; yet, despite having the same disclosure materials, neither the company nor Young were ever cited or reprimanded prior to a Receiver being appointed during bankruptcy.

Why this case is notable:

This case may finally provide compliance officers some clarity as to their responsibilities and the potential liability associated with failing to abide by those responsibilities. When it makes its ultimate decision in Young’s appeal, the Commission could take this opportunity to clearly articulate some of the standards of care that it expects of compliance officers. In addition to addressing compliance officer liability, it also speaks to the SEC use of administrative hearings for complex cases.

In re State Street Bank & Trust Co.,
Securities & Exchange Commission

Conduct and Claims:
On January 14, 2016, State Street Bank and Trust Co. (“State Street”) consented to entry of an order instituting cease-and-desist proceedings against it (the “Order”), without admitting or denying the SEC’s findings. The SEC alleged that a State Street executive, Vincent DeBaggis, and an outside lobbyist, Robert Crowe, operated a pay-to-play scheme to win the firm contracts from Ohio pension funds. The Order alleges, among other actionable conduct, that DeBaggis made a deal with former Ohio deputy treasurer and Chicago comptroller Amer Ahmad to exchange cash payments and political campaign contributions in return for sub-custodian contracts for certain investment assets. In March 2010, State Street made campaign contributions for Ahmad, by funneling them through a third party, with $16,000 going through Crowe’s personal bank account.

“While awaiting a response from the Compliance Department, DeBaggis suggested . . . that, in lieu of direct contributions, DeBaggis could offer Crowe’s services to assist in the Treasurer’s fundraising campaign . . . . [Ahmad] rejected this proposal outright, stating: “We want to see money, checks.”

Reasoning and Result:
The actions of the State Street executive violated the bank’s Standard of Conduct, and the use of the lobbyist to funnel contributions to the state official’s campaign circumvented direct instructions of the bank’s compliance department. After obtaining the sub-custodian contracts, the executive signed an agreement making representations that he and the company had complied with state pay-to-play laws—representations he obviously knew to be false. The SEC alleged violations of the anti-fraud provisions and Rule 10b-5 of the Securities Exchange Act. State Street was notified by the SEC and thereafter fully cooperated with the investigation, also conducting an internal investigation into the matter and appointing and independent firm to investigate as well.

DeBaggis settled with the SEC and agreed to pay $174,000 in disgorgement and interest, and $100,000 in civil penalties.

Despite the remedial actions taken by State Street and its cooperation with the SEC, State Street paid $12 million to settle the matter with the SEC.

Why this case is notable:
This case demonstrates the SEC’s increased focus on holding both individuals and their corporate employers responsible for securities law violations.


**Conduct and Claims:**

Former trustors and beneficiaries of a charitable annuity trust brought action against entities providing financial and investment services ("Investment Entities") to the trust under a variety of theories—focusing on alleged damage to the value of the trust assets—including breach of trust, breach of contract, failure to supervise other defendants, breach of fiduciary duty, negligence, violation of the anti-fraud provisions of the securities laws of Nebraska, and common law fraud. Plaintiffs alleged that the Investment Entities used their powers to "materially change" the investment policy and investment objective of the trust to a “materially riskier and more aggressive investment policy” resulting in a decline in the trust’s value.

**Reasoning and Result:**

The court found that the plaintiffs lacked standing to pursue action against the Investment Entities on behalf of the trust, and with respect to their personal claims, they suffered no damages. The court reasoned that the proper person to bring suit against the Investment Entities was the trustee and that the plaintiffs failed to show any evidence that the trustee was unable or unwilling to bring suit. The court also reasoned that because the plaintiffs sold their interest in the trust (which they admitted in their deposition), they were unable to enforce a cause of action on behalf of the trustee. Finally, the court reasoned that while the plaintiffs had standing to pursue claims that were personal to them, there were no damages as the plaintiffs received their annual distributions from the trustee up until the time they sold their interest.

“Even if a shareholder establishes that there was a special duty, he or she may only recover for damages suffered in his or her individual capacity, and not injuries common to other shareholders.”

**Why this case is notable:**

Generally, a trust is not a legal personality and the proper person to sue on behalf of the trust is the trustee. Beneficiaries of the trust may enforce a cause of action against a third party only if the trustee cannot or will not do so. By failing to even request the trustee to assert the cause of action, the beneficiaries were the wrong party to bring an action on behalf of the trust, and, therefore, lacked standing. Moreover, the beneficiaries had sold their interests in the trust prior to filing their complaint. Thus, even if they had established that the trustee could not or would not enforce a cause of action, they were unable to act on behalf of the trust. The court also analogized this situation to that of a corporate shareholder: “Even if a shareholder establishes that there was a special duty, he or she may only recover for damages suffered in his or her individual capacity, and not injuries common to other shareholders.”
**Conduct and Claims:**

A trust beneficiary filed an action against an institutional trust company serving as trustee of a trust for breach of fiduciary duty, negligence, breach of contract, conversion, and unjust enrichment. The beneficiary alleged that the trust company breached its fiduciary duties by taking stock as collateral, serving as trustee over a trust that controlled its own stock and failing to diversify the trust assets when the stock began losing value.

“In extremely general terms, Plaintiff Kay Hood Adams borrowed $3 million from Regions. She secured the loan with Regions stock that was held by a limited partnership her family owned. After the stock was encumbered, a trust established by Adams’ late father became the 99% owner of the limited partnership that held the Regions stock. That trust contained a spendthrift provision that prevented Adams from offering trust assets as security. After all of this occurred, Adams and others signed documents making Regions the successor trustee for the spendthrift trust. Thus, Regions became the trustee over a trust that held Regions’ stock.”

**Reasoning and Result:**

The court dismissed all claims against the trust company except for the failure to diversify claims on the grounds that the statute of limitations for those claims had run or the beneficiary failed to present any evidence to support her claim. For the failure to diversify claim, the court reasoned that the trust agreement (and the settlor’s intent) explicitly provided that the trustee did not have to diversify so long as the beneficiary did not exercise her authority to instruct the trustee to sell. Because the beneficiary did not instruct the trustee to sell, the trust company did not have to diversify the trust’s investments.

**Why this case is notable:**

Mississippi adopted the Uniform Prudent Investor Act which provides that a trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. The court reasoned that special circumstances existed in this case. First, that the trust agreement specifically allowed the trustee to retain trust property without regard to diversification or risk and without liability. Second, the beneficiary who brought suit approved of the retention of stock by the trust company despite the fact that it was the trust company’s own stock.
Perlman v. Wells Fargo Bank, N.A., 559 F. App’x (11th Cir. 2014).

**Conduct and Claims:**
For more than a year, George Theodule, a Haitian national, operated a massive and widespread Ponzi scheme targeting Haitian-Americans in South Florida, Atlanta, New Jersey, and Chicago. Holding himself out as a Christian pastor, Theodule promised investors he would double their investment within 90-days, with little or no financial risk, and that he was offering his investment expertise to help build wealth within the Haitian community. The court-appointed receiver of entities used to perpetrate the scheme brought action against a bank alleging, among other things, that the bank aided and abetted the operation of the Ponzi scheme.

**Reasoning and Result:**
The court dismissed the claims against the bank on the grounds that the factual allegations did not sufficiently establish that the bank had “actual knowledge” of the underlying wrongs committed. The court reasoned that while the accounts, transfers among the accounts, lack of investment activity, and other similar acts were enough to arouse suspicions for the bank, they were not sufficient to trigger any obligation to investigate. The court further reasoned that these red flags, while they may serve to put a bank on notice that some impropriety is taking place, do not create a strong inference of actual knowledge—which is the standard required for establishing an aiding and abetting claim. These red flags consisted of various “procedural oddities, including: Theodule’s opening of various accounts, numerous transfers amongst the accounts within short time periods, thousands of deposits of even dollar amounts, large cash deposits and withdrawals, the absence of any investment activity, and Wells Fargo’s lifting of the freeze on the Wealth Builders account without further investigation.”

**Why this case is notable:**
In Florida, in order to properly allege a claim of aiding and abetting a breach of fiduciary duty, a party must demonstrate that the third party (i.e., the aider or abettor) had “actual knowledge” of the wrongdoing. While actual knowledge may be shown by circumstantial evidence, the circumstantial evidence must demonstrate that the aider and abettor actually knew of the underlying wrongs being committed. Merely alleging that a bank should have known of wrongdoing based on a typical transaction is not sufficient to survive a motion to dismiss. The court reasoned that in this matter, the facts alleged only provided incidents that aroused suspicion, but did not evince actual knowledge by the bank of any wrongdoing.

However, the court also importantly found that the bank could plausibly have actual knowledge of the fraud where a proposed complaint showed that the bank’s fraud investigator looked into the accounts and concluded that the activity “raise[d] the hair on the back of your neck”, and the bank still kept the account open for three months after that determination.
Headlines: The Fiduciary Forum

Tom Benson and Donald Sterling – A Tale of Two Capacities

On February 24, 2016, a New Orleans appeals court upheld a judge’s 2015 ruling that Saints and Pelicans owner Tom Benson was mentally competent to make decisions about his financial affairs. Last year, Benson’s daughter Renee made headlines when she and her children filed a petition seeking to have the billionaire Benson declared mentally incapacitated.

The lawsuit arose when Benson announced that his third wife Gayle would inherit control of his businesses instead of Renee and her children. The lawsuit claimed that Benson lacked capacity and had been manipulated into making that change by Gayle. Three physicians testified, although Benson did not appear as a witness. Two of the physicians (one neutral and one chosen by Benson) said Benson should not be barred from handling his financial affairs despite mild cognitive impairment. The third physician (chosen by Benson’s relatives) said Benson was unable to consistently make reasoned decisions about his property. The judge ruled in favor of Benson, and the decision was ultimately upheld on appeal.

Benson’s case echoes another high-stakes capacity battle in 2014 involving billionaire and former Los Angeles Clippers owner Donald Sterling. In that case, Sterling’s wife Shelly filed a petition claiming he was mentally incapacitated— at stake was control of the NBA Clippers franchise, which was held in a revocable trust of which both Sterling and Shelly were co-trustees. Shelly’s lawsuit arose around the time of the public release of racially derogatory comments by Sterling. In response, the NBA imposed a lifetime ban on Sterling, penalized him with a multi-million dollar fine, and began the process to force Sterling to sell the team.

Two independent physicians examined Sterling and determined he had diminished cognitive capacity. The probate court determined that Sterling lacked mental capacity and disqualified him from serving as co-trustee. The court also confirmed Shelly’s authority to sell the team. Unlike Benson’s case, Sterling himself testified during the trial, and it is likely that his belligerent and strange testimony undermined...
his case for capacity. After the court’s ruling, Shelly completed the $2 billion sale of the Clippers to former Microsoft CEO Steve Ballmer.

**The Issue of Diminished Capacity**

Although these two cases resulted in different outcomes, they both highlight the issue of diminished capacity and its ripple effect on trust administration and control of trust assets including, sometimes, billion dollar businesses. Given the growing increase in the population of persons over 65 years old, and the prevalence of Alzheimer’s disease and other forms of dementia, the issue of diminished capacity is a critical one.

Capacity, for purposes of executing estate plan documents, has been defined as the donor having a general sense of the nature and value of the donor’s assets and the identity of the natural objects of the donor’s bounty, being free from undue influence, and understanding that the documents intend to dispose of assets (as contrasted with signing a greeting card, for example). But there are different standards for wills and trusts. In California, for example, the court in *Anderson v. Hunt*, 196 Cal. App. 4th 722 (2011), set forth a sliding scale of testamentary capacity for trusts and trust amendments depending on the level of complexity of the document. Specifically, the “[m]ore complicated decisions and transactions thus would appear to require greater mental function; less complicated decisions and transactions would appear to require less mental function.” *Id.* at 730.

Donors can have “lucid moments” in the mist of otherwise diminished capacity sufficient to execute documents. Previously, donors under guardianship or conservatorship generally were thought not to have testamentary capacity, but an estate plan could be created for them using special estate planning statutes under local guardianship statutes. The trend has been to have a proceeding that confirms the person in need of protection’s testamentary capacity, without the need for court approval of the actual estate plan documents.
The Challenge for Fiduciaries

Private and professional fiduciaries are becoming increasingly confronted with clients who at some point may become unable to manage their financial affairs. The evolution of protective statutes in family and probate courts has become increasingly protective of the right of individuals believed to be eccentric and damaging to their own financial interests. At the same time, the role of the corporate custodian and trustee has become increasingly complicated by these changes.

In some cases, diminishing capacity becomes apparent over the course of time. For example, an individual co-trustee might participate in a conversation about changing trust investments cogently and then have no recollection of the discussion when presented with the documents to effect the changes several days later. Or, another family member may alert the Trustee out of concern or with an agenda to effect a change in the trusteeship.

For fiduciaries serving as co-trustees, slowly changing capacity can present problems both in detection and response. Individuals and their families often are unwilling to recognize changes in capacity, or even if there is acknowledgement that capacity is reduced, there is a reluctance to require the individual to undergo an examination, or at a minimum, receive notice of removal.

It is imperative for fiduciaries to maintain open communication and consider options together with clients, particularly on the intake of new business, to address these issues. Take for example the Sterling case. This is the classic case of someone who appears to have diminished capacity but still retains sufficient capacity to challenge a shift in control over the management of his trust assets. Fortunately, the Sterling Trust contained clear language that if either Sterling or Shelly died or became incapacitated, the other would serve as sole trustee. The Sterling Trust also provided that a finding of incapacity required the assessment of two independent doctors.

While the language in a trust will not prevent a donor who thinks he or she is not impaired from challenging removal, the language provides guidance to the court in the event the donor does challenge the physician assessment or the judgment of the decision makers. In a close case, the court should be expected to defer to a
finding that the donor has capacity, particularly with a revocable trust, such as in the case of Tom Benson.

As an interesting footnote, there was collateral trust litigation involving Benson concerning his second wife Shirley’s testamentary trust (which does not hold any interest in the New Orleans Saints or Pelicans). Shirley’s trust holds shares in a family-owned bank, car dealerships, and real estate. Renee sought to get control of her deceased mother’s trust because Benson was unable to manage it. Before trial, Benson and his daughter Renee reached a settlement agreement in which Benson turned over control of Shirley’s trust to Renee.

**David Bowie’s Will Splits Estate Said to Be Worth $100 Million**

David Bowie died January 10, 2016, leaving behind an estate believed to be worth $100 million. In his Last Will and Testament, Bowie made several specific bequests (testamentary gifts of specific items of property) to those close to him. One of Bowie’s most sizable specific bequests was a SoHo penthouse he purchased in 1999 for $4 million, which he left to his widow, Iman Abdulmajid Jones. Bowie left his daughter, Alexandria Zahra Jones, a mountain retreat in Ulster County, New York through a trust set up on her behalf since she is under 18-years old. In addition, Bowie made specific bequests of cash and stocks to others including his longtime personal assistant and a nanny.

With the remainder of his estate, Bowie left fifty-percent to his widow, twenty-five percent to his son, Duncan Jones, and the final twenty-five percent to his daughter Alexandria in trust.

Bowie, who held Bali in high regard, stated that he wanted his body shipped to Bali and cremated there in accordance with Buddhist rituals. If cremation in Bali was not possible, Bowie at least wanted his ashes scattered there. Bowie’s death certificate indicated that he was cremated in New Jersey on January 12, 2016.

See James Barron, N.Y. TIMES (Jan. 29, 2016).