SUPERVISION OF THIRD-PARTY/ POWER OF ATTORNEY ACCOUNTS

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Introduction

Third-party/power of attorney accounts[1] have been a problem for broker-dealers (BDs) for decades, but an alarming new problem has raised its ugly head: third party/power of attorney accounts at online/internet brokerage firms such as Schwab, E-Trade, TD Ameritrade (Ameritrade) and Scottrade. Whatever problems brick-and mortar-BDs have with these types of accounts doesn't compare to the dangerous situation and fraud being perpetrated on thousands of American investors in their brokerage accounts at online firms. Sadly, the regulators have once again been asleep at the wheel as to these issues. The hope of the authors Douglas Schulz and Tracy Stoneman[2] is that this article will prompt the SEC, FINRA and the state regulators to wake up.

Definition of a Third-Party/Power of Attorney Brokerage Account

A power of attorney (POA) account can arise in three distinctly different situations. One is where an investor gives trading authority to his or her broker or investment adviser who is employed by the broker-dealer where the

1. Third-party trading authority, power of attorney, and discretionary trading authority are used synonymously throughout this article.

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investor's account is held. These are also called discretionary accounts. The second is where an investor gives trading authority to a third party who is a licensed investment adviser, but the adviser is not affiliated with the BD where the account is being held. The third situation is where an investor gives a POA to a spouse, family member or friend. Each of these situations has its own unique requirements and problems, but first let's address the general requirements of a POA.

Perhaps the most sacrosanct requirement of broker-dealers is to establish in writing at the opening of any brokerage account who will have authority to perform certain tasks associated with the account. Fulfilling this requirement is generally pretty straightforward when an account is a basic, individual account and there is only one named owner. Without further documentation, it is assumed that the named account holder is in the sole position to make any and all decisions regarding trading in the account. The same is true when an account is opened by a married couple, that is, each spouse has the same rights when it comes to making decisions for the account. But that is where the simplicity ends.

The following are just a few of the types of accounts that create questions as to who does or does not have authority in an account:

- A spouse trading in the account of the other spouse, when the account is titled in only one spouse's name
- A spouse trading in the account of a son, daughter, parent or grandparent
- Corporate and business accounts
- Pension and other retirement accounts
- Trust and estate accounts
- Investment adviser accounts

In each of these types of accounts, the BD must have in writing a legal document making it clear who has authority to make certain decisions. The regulations and internal policies of the BDs require that this written authority be in place before any transaction of any kind takes place.[3]

3. *See* FINRA, RULE 408 (2008) and FINRA, RULE 4512 (2011) ("the member shall maintain a record of the dated, manual signature of each named, natural person authorized to exercise discretion in the account.")

Types of Authority

In something close to 90% of accounts where there exists a POA, it is in the form of a limited power of attorney. The limitation most often is that the person with the POA can only make investment decisions and enter buy and sell orders. Even though, as we will discuss in detail later, this person can harm an account through unsuitable investments, the higher risk is when authority is given to a third party to withdraw money or securities from the account.

The second type of authority is a full power of attorney. This authority goes beyond the mere management of investments and allows the withdrawal of funds from the account. Most firms require that any request for withdrawals/disbursements be sent to the only person that has been preapproved by the account owner.

Licensed Versus Unlicensed

There is no securities regulation that forbids a BD from giving a POA to an individual who is not licensed in the securities industry. How the various BDs deal with this issue is quite a hodgepodge. We found some smaller BDs that will not allow a person to be a POA if they are unlicensed, unless they are a family member. The brick-and-mortar BDs generally have stricter policies in this area.

Although licensing is not a complete safeguard against wrongdoing, the authors strongly believe that unless the POA is a family member or there are special, legal circumstances, that anyone with a POA should be licensed. Nor should a POA holder's status as a family member indicate a lesser level of supervision. The authors have been involved in multiple cases where the son ripped off his parents' accounts, a husband abused his wife's account, and just about every combination that you can imagine. BDs should scrutinize both the authority and the accounts when a POA is given to a family member, as in other circumstances.

The Institutional Game

The institutional game is a new, unethical defense tactic being used extensively by the internet/online broker-dealers. FINRA regulations have carved out exceptions for the broker-dealers if the investment account is an institutional account. If the account meets the criteria for being an institutional

account, there are certain duties and obligations that are lessened on the part of the broker-dealer. The following is the definition of an institutional account:

> (c) For purposes of this Rule, the term "institutional account" shall mean the account of:
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> > (1) a bank, savings and loan association, insurance company or registered investment company;
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> > (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or
> >
> > (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.[4]

One specific area where this institutional coding changes the requirements is suitability. The following is FINRA 2111, the suitability rule:

> 2111. Suitability
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> (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.
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> (b) A member or associated person fulfills the customer-specific suitability obligation **for an institutional account**, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional

4. FINRA, RULE 4512 (2011).

> customer has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.[5] [emphasis added]

Yet online firms routinely code individual retail accounts, whose owners have provided third-party trading authority to an independent agent, as institutional. The practice of online firms coding individual accounts as institutional is not only wrong, it does not comport with the language and definition of what an institutional account is. The definition is clear – it's three categories of individuals/entities. The first definition is an actual entity, like a bank or a pension plan or an insurance company. In other words, an actual institution is the account holder. The second definition is very specific – it includes only investment advisers registered at the state or federal level. When third-party investment advisers manage the accounts of multiple investors, it is not uncommon for the investment adviser to open up a master account. The account of that adviser, under the institutional customer definition, would be an institutional account. The third definition is any other person or entity with assets of $50 million or more.

Regular people who hire independent investment advisers and who then have accounts opened for them at online broker-dealers where they provide the adviser a limited trading authorization do not meet the definition of an institutional account. Yet, the online firms are ignoring the definition. An example, from one of Tracy's cases, is the account application from Ameritrade, attached as Appendix A. We see at the top of the form "TD Ameritrade Institutional" and the top box identifies the investment adviser. Box number two identifies the Account Owner - this is the individual who Tracy represents. Tracy's client is Ameritrade's customer, client, and the account owner, yet Tracy's client fits none of the three definitions of an institutional account! And note that this account application form contains none of the "customer profile" data required by FINRA Rule 2111(a). By coding the account "institutional," a firm can essentially ignore its clients.[6]

Another game being played by particularly the online broker-dealers is with their manipulation of the "factors" that are to be applied to the agent pursuant to FINRA Rule 2111. Paragraph (b) references "these factors" to be applied to the agent, however, the identification of "these factors" isn't found

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5. FINRA, RULE 2111(a)-(b) (2014).

6. All broker-dealers have policies, even if for their own protection, that dictate that they obtain enough financial information to make sure that any client opening a margin account has the financial wherewithal to handle the complexity of margin trading.

only in paragraph (b) but also in paragraph (a). What the broker-dealer must obtain from the power of attorney/agent is some of the customer profile information that would otherwise be obtained from the customer. This would include such information as the agent's investment knowledge and investment experience. We are aware that Schwab's Power of Attorney form requests this and other detailed information about the agent, such as date of birth, employment, address, email address, driver's license number, marital status, and number of dependents of the agent.

Admittedly, it is rather confusing and it is FINRA's fault. In 2012, the Securities Industry and Financial Markets Association (SIFMA), the brokerage industry's lobby, prepared for distribution a form for broker-dealers to use in order to comply with FINRA Rule 2111 and the institutional exemption. SIFMA's announcement read:

SIFMA Develops New Institutional Suitability
Certificate to Facilitate Compliance with New
FINRA Suitability Requirements[7]

However, a copy of its form attached as Appendix B, contains no information other than the two items in FINRA Rule 2111(b) concerning "evaluating investment risks independently" and "exercising independent judgment." FINRA could do a much better job in clarifying what information broker-dealers must obtain from the power of attorney/agent.

Yet another consequence of coding individual, retail accounts who have hired independent investment advisers as institutional is that firms can then rely on FINRA's Margin Disclosure Statement rule to not provide disclosure statements to such customers:

> 2264. Margin Disclosure Statement
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> (a) No member shall open a margin account, as specified in Regulation T of the Board of Governors of the Federal Reserve System, for or on behalf of a **non-institutional customer**, unless, prior to or at the time of opening the account, the member has furnished to the customer, individually, in paper or electronic form, and in a separate document (or contained by itself on a separate page as part of another document), the margin disclosure statement specified in this paragraph (a). In addition, any member that permits **non-institutional customers** either to open accounts online or to engage in transactions in securities

7. Press Release, Securities Industry and Financial Markets Association, SIFMA Develops New Institutional Suitability Certificate to Facilitate Compliance with New FINRA Suitability Requirements (Feb. 23, 2012) *available at* http://www.sifma.org/news/news.aspx?id=8589937525.

> online must post such margin disclosure statement on the member's Web site in a clear and conspicuous manner. [emphasis added][8]

If the account is "institutional," FINRA Rule 2264 is not triggered, which means that firms that improperly code individual, retail accounts as "institutional" are not required to provide those clients with the Margin Disclosure Statement.[9]

It is our strong opinion that when the account owner is an individual (with less than $50 million in assets), that account is a retail, individual brokerage account, not an institutional account. And it should benefit fully, as any other individual retail account would, from all of the regulations and policies that might protect it from abuses of any kind. We've seen this institutional game by the internet brokerage firms used regularly. The worst part is that where we have seen this improper coding/titling of the account most often is in some of the cases where the largest numbers of investors are defrauded.

The Risks and Problems of POA Accounts

Far too many individuals in the brokerage industry are unaware of the most basic risks associated with POA accounts. And to some degree, we can say the same for the regulators. Unfortunately, the regulators have allowed the brokerage industry, mainly the internet, discount broker-dealers,[10] to create dangerous situations in millions of accounts where there exists a POA.

When a power of attorney is in place, by definition, the account owner is less involved in the management and investment decisions of the account. Indeed, it is far more typical that when a POA is granted, the account owner is not involved at all in day-to-day investing decisions or active monitoring of account activity.

Partly for these reasons, discretionary accounts, that is, accounts where someone other than the account owner is making all the investment decisions for the account, have always been considered by the brokerage industry to be

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8. FINRA, RULE 2264 (2011).

9. FINRA, RULE 2360 (2014) (Options) does not have an "institutional" exemption and the Option Disclosure Statement must be provided to any customer who is approved for option trading.

10. This is not the first time Mr. Schulz has expressed criticism of internet brokerage firms. Douglas J. Schulz, Invest Securities Consulting Inc., No Duty - Does Suitability Apply to Internet Brokerage Firms?, Presentation at the Annual Meeting of the Public Investor's Arbitration Bar Association, (Oct. 2000).

the most potentially problematic accounts. There is an inherent safeguard in the normal broker-client relationship where each and every investment decision is discussed in advance, because although a naïve investor might not fully understand every single investment the broker recommends, he or she at least is fully aware of what's taking place with respect to every single trade.

Contrast this with a discretionary account, where somebody with a POA is making every single investment decision without any communication whatsoever with the account owner. The investor can be completely in the dark. At the majority of brick-and-mortar brokerage firms, management and compliance is aware of that fact. And they have policies and monitoring practices that make sure that they give special attention and conduct detailed due diligence into how managed, discretionary accounts are being invested and traded. Yet, at the online/internet brokerage firms, POA accounts often receive little or no supervisory attention, and regulators have done little to require such firms to conduct adequate supervision.

The overriding potential problem with POA accounts is the fact that the account owner is not making the day-to-day decisions for the account and often pays very little attention to the account. Considering that this is the circumstance in the vast majority of all POA accounts, the regulators, BD compliance departments, and local branch office managers should have both a heightened awareness and a policy to regularly conduct extensive due diligence to ensure that each and every POA account is not being abused.

Know Your Customer *and* The Power of Attorney!!

Perhaps no regulation other than suitability has been written about as much as the "Know Your Customer" rule. Our main focus here is to address how the "Know Your Customer" rule relates to the issue of third-party authority. But before we do so, there are some side issues we must first put in perspective.

When testifying in arbitration, Douglas often likes to describe the regulation on suitability as an A, B, C process. First, the stockbroker/adviser is required to exercise diligence in learning the essential facts relating to the investor. This includes such things as age, employment, investment experience, investment knowledge, financial needs, investment goals, and risk tolerance.[11] But under the regulations, there is no complete list. Instead, it is

11. FINRA, RULE 2111 (2014). Suitability (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer,

all the "essential" facts that need to be learned about each investor. Specifically, FINRA Rule 2090 states the following:

> 2090. Know Your Customer
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> Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.
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> • • • Supplementary Material: --------------
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> .01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.[12]

The "B" part of the process is the requirement that the broker/adviser conduct reasonable diligence to learn the essential facts about the particular investment that he is thinking of recommending to his client.[13] That would include such items as the nature of the investment, the industry or sector of the investment, the history of the investment, profitability, the management, the goals, and most importantly the associated risks.[14] Again, this list is by no

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based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. *Id.* A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. *Id.*

12. FINRA, RULE 2090 (2012).

13. "FINRA notes that it replaced the term 'due diligence' used in former NYSE Rule 405(1) with the term 'reasonable diligence' in new FINRA Rule 2090 for consistency with the language used in new FINRA Rule 2111. FINRA did not intend by such action to impair or adversely affect established case law and other interpretations discussing the diligence that is required to comply with know-your-customer or suitability obligations." FINRA, REGULATORY NOTICE 11-02 (2011).

14. For additional information on the requirements for due diligence *see* Douglas Schulz, *Due Diligence: Securities Applications and Regulatory Requirements*, 17 PIABA B.J., 4 (2010). This article addresses the due diligence obligations of financial professionals such as brokers, broker-dealers, investment advisers, hedge fund managers, and private placements.

means complete. The broker/adviser is required to learn all the essential facts so he can properly determine if the investment is suitable based on what he knows about his client. Finally, there is the "C" part of the process. The broker is now required to take what he knows about the client and compare it to what he now knows about the investment and make a determination if he should even recommend the investment to the client, that is, is the investment suitable for the client.

For those of us who have been in the securities industry for decades, we often referred to the "Know Your Customer" rule as New York Stock Exchange Rule 405:

> Rule 405. Diligence as to Accounts
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> Every member organization is required through a principal executive or a person or persons designated under the provisions of Rule 342(b)(1) to:
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> ***(1)*** *Use due diligence to learn the essential facts relative to* every customer, every order, every cash or margin account accepted or carried by such organization and *every person holding power of attorney over any account accepted or carried by such organization.*[15]

Over the last decade, it's been a challenge for those in compliance and supervision. First, we had the regulatory authority for the NYSE rolled into the NASD. Then we had the NASD rules renumbered for FINRA. The net result is going forward (depending on the exact years relating to the potential securities violations), we don't find ourselves quoting NYSE Rule 405, but instead the new FINRA Rule 2090. Below is a section from FINRA Regulatory Notice 11-02 on the Know Your Customer rule and NYSE Rule 405:

> Know Your Customer
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> In general, new FINRA Rule 2090 (Know Your Customer) is modeled after former NYSE Rule 405(1) and requires firms to use "reasonable diligence,"4 in regard to the opening and maintenance of every account, to know the "essential facts" concerning every customer. The rule explains that "essential facts" are "those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."7 *The know-your-customer obligation arises at the beginning of the customer-broker relationship*

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15. NYSE, RULE 405 (2010) [emphasis added].

> *and does not depend on whether the broker has made a recommendation*. Unlike former NYSE Rule 405, the new rule does not specifically address orders, supervision or account opening—areas that are explicitly covered by other rules.[16]

The regulators have made it clear that despite the fact that there is no broker making a recommendation, as is the case at online/internet firms, the "Know Your Customer" obligation still applies. That is why the account applications/new account forms at some online firms ask many of the same litany of questions as if the account were being opened at a full service, brick-and-mortar firm.

The landscape changes dramatically, however, with the introduction of an independent third-party adviser. We have already described how online firms are miscategorizing accounts with third-party advisers as institutional and how firms use this categorization to *not* know their customers as they should.

The main thrust of this article, however, is that the brokerage industry and more specifically the internet/online discount brokerage firms such as Schwab, Ameritrade, E*Trade, and Scottrade are failing to conduct due diligence to obtain the essential facts about individuals that they are giving trading authority to and who manage thousands of accounts worth hundreds of millions of dollars.

It is our opinion that the "Know Your Customer" rule is sacrosanct. And it is our opinion that the current regulations in fact require all broker-dealers to apply the "Know Your Customer" rule to include anyone with power of attorney over the account. The following is the support for our opinion.

> NYSE Rule 405: *(1) Use due diligence to learn the essential facts relative to* every customer, every order, every cash or margin account accepted or carried by such organization and *every person holding power of attorney over any account accepted or carried by such organization.*[17]

Although the words are slightly different in the new FINRA Rule 2090, there was no intent to change the original meaning of NYSE Rule 405:

> FINRA Rule 2090
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> Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and *concerning the authority of each person acting on behalf of such customer.*01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are

16. FINRA, REGULATORY NOTICE 11-02 (2011).

17. NYSE, RULE 405 (2010) [emphasis added].

> those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) *understand the authority of each person acting on behalf of the customer*, and (d) comply with applicable laws, regulations, and rules.[18]

Since firms are required to learn the essential facts concerning "the authority" of each person acting on behalf of the customer, it is reasonable that the diligence exercised would include uncovering facts that might compromise such authority. For example, if the independent adviser had a record of customer complaints, regulatory actions, bankruptcies, or inexperience, these are essential facts that concern the authority of the independent adviser.[19] And, as FINRA stated in Regulatory Notice 11-02, the "reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case."[20]

FINRA clarified that obtaining the essential facts from the customer or power of attorney is not static and is to take place beyond just the opening of the account:

> *A broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts.* Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information. As with a customer's investment profile under the suitability rule, *a firm should verify the "essential facts" about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account* that might result from the customer's change in circumstances. *The reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case.* Firms should note, however, that SEA Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain

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18. FINRA, RULE 2090 (2012).

19. FINRA's Option Rule 2360(b)16(B)(ii)(b) requires firms to obtain the "Discretionary authorization agreement on file, name, relationship to customer and experience of person holding trading authority." Such experience would include option experience specifically. FINRA, RULE 2360(b)(16)(B)(ii)(b) (2014).

20. FINRA, REGULATORY NOTICE 11-02 (2011).

> account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations.[21]

Another important point are the words "mishandling of a customer's account." By definition, preventing mishandling of a customer's account is the primary obligation of the securities industry's self-regulatory organization, FINRA. Note the following language from FINRA's website and its description of "What We Do":

> 1. Deter misconduct by enforcing the rules
>
> FINRA's mission is to safeguard the investing public against fraud and bad practices. We pursue that mission by writing and enforcing rules and regulations for every single brokerage firm and broker in the United States, and by examining broker-dealers for compliance with our own rules, federal securities laws and rules of the Municipal Securities Rulemaking Board.[22]

One of the more interesting aspects of what the broker-dealers are required to know about anyone with a POA is seen by looking at the hodgepodge of what some of the BDs require currently about anyone with a POA. We have heard arguments from the internet brokerage firms that the new "Know Your Customer" Rule 2090 does not have the same requirements as the old NYSE Rule 405. They argue that instead of previously needing to know all the "essential facts" relating to someone with power of attorney, now they only need to 'understand the authority'. However, seemingly contrary to this argument, numerous BDs currently require quite a lot of information about a POA.

One particular internet brokerage firm's POA form starts with the words, "Securities industry regulations require that we collect the following information" before asking for information about the POA. Interesting, because other internet brokerage firms request very limited information from the POA. The firm with better policies asked the following about the POA:

- how the individual is employed;
- marital status and number of dependents;
- investment experience;
- annual income;
- liquid net worth;
- if the individual is being compensated and how; and
- investment adviser registration ID (IARD).

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21. FINRA, REGULATORY NOTICE 11-02 n.5 (2011) [emphasis added].

22. Financial Industry Regulatory Authority, *What We Do*, http://www.finra.org/about/what-we-do.

Merrill Lynch, in addition to a lot of other information, requires that when a third-party, POA account is opened for an outside investment adviser that the firm document "the relationship to the designated owner."

It is our strong opinion that the obligation of the broker-dealer to diligently uncover essential facts on anyone holding a POA on an account is more paramount than the basic Know Your Customer rule as it applies to the account owner. There is even more of a reason for heightened due diligence as relates to third-party accounts based on the actions, or inactions, of the broker-dealers.

Here is a list of the minimum all brokerage firms (especially internet and online BDs) should obtain and document about the POA:

- name, address, date of birth, Social Security number, email, phone number;[23]
- business name, business affiliates, details of employment, DBAs, sources of income;
- verify the registration status and history of not just the RIA entity but all individuals who have authority on the account;
- copies of the last three years' ADV forms which should be reviewed in detail to address any material issues. Additionally, require and scrutinize the RIA's updated annual ADV;
- obtain the RIA's current and past CRD, FINRA filings, review and address any material issues, including all information on prior complaints;
- Obtain the RIA's U-4s and U-5s to review questionable employment history or any history of customer complaints. Address any material issues;
- full, prior work history and note any frequency in changing firms (a red flag);
- a separate questionnaire asking if any complaints have been expunged;
- information from broad databases on any litigation or bankruptcies;
- a comprehensive credit check;
- contact various state securities boards as to any past or pending investigations or litigation;
- direct phone contact with prior employer or BD he was clearing through;
- a separate questionnaire documenting how the relationship with the account holder was formed and when; and
- review of the POA's website and review of all marketing materials.

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23. Under the Bank Secrecy Act and the Patriot Act, broker-dealers are required to obtain basic information from anybody having a POA on an account.

The due diligence to obtain this information should be updated no less than every three years, which is the basic regulatory requirements for other accounts.[24]

Monitoring

At the very heart of the securities regulations and firm policies on compliance and supervision is the practice of monitoring the firm's brokers and advisers and the monitoring of the brokerage accounts themselves. Almost every broker-dealer in the country now has sophisticated, computerized screening systems that, on any given day, can spit out volumes of detailed analysis on such things as:

- broker's monthly commissions;
- broker's commissions broken down by product;
- percentage of brokers' commissions in any one account;
- commissions as a percentage of account equity;
- number of trades in an account for the month;
- percentage of trades that are profitable;
- profit and loss for the month;
- profit and loss year-to-date;
- account performance when compared to various indexes;
- percentage of trades that are short-term;
- concentration in a particular security;
- concentration in type of security or sector;
- unusual withdrawals and disbursements;
- frequency and size of margin calls; and
- number of margin calls met through liquidations.

FINRA's supervision Rule 3110 to some degree can be broken into three parts: a) firms are required to have written policies and procedures addressing a myriad of brokerage activities; b) firms are required to monitor their brokers and their accounts to make sure these policies and all securities regulations are being adhered to; and c) firms are required to document all supervisory and compliance activity.

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24. The Securities Exchange Act of 1934 Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations. 17 C.F.R. § 240.17a–3 (2008).

Internet brokerage firms far too often fail miserably in their obligation to know their customers and anyone holding power of attorney over the account and exacerbate this problem by failing to monitor accounts for any potential conflicts or abuses.

Transfers & Withdrawals

As we discussed earlier, it is rare for the authority given to a third party to include the ability to effectuate transfers and withdrawals, thus the term "limited" authority /power of attorney. Even when a broker-dealer does allow an account owner to give an individual "full" authority, which includes transfer and withdrawal authority, there are almost always restrictions on those withdrawals and transfers. For example, most all broker-dealers require that the POA's request for funds to be distributed must be mailed to an address that is pre-designated and signed by the account owner.

Even with a limited power of attorney, though, investors grant their advisers the authority to communicate with the BD about disbursements from the accounts. For example, Ameritrade's Advisor Service Account Application states:

> Authorization to Direct Disbursement or Funds. By providing my signature on this Fee Payment and Trading Authorization I am providing authorization for the Clearing Firm to remit checks wire funds, and otherwise to make disbursements of funds held in the Clearing Firm Account to banks, broker/dealers, investment companies or other financial institutions for my benefit, upon Advisor's verbal, written, or electronically transmitted instructions.[25]

Based on this authorization, an unscrupulous independent adviser could authorize the firm to transfer funds to his brokerage account held at another firm, and verbally at that! We doubt that investors and even the regulators are aware of this loophole language in a limited power of attorney. Scottrade's Investment Advisor Limited Trading and Fee Authorization has something similar:

> My Investment Advisor is permitted to request the disbursement of funds from the account(s) listed below, provided the funds are sent to the registered name and address on file for the account(s). To disperse funds from the account(s) to an alternate payee or address, I must

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25. Ameritrade, *Advisor Service Account Application,* (on file with author).

submit a written request to Scottrade. I must also submit a written request to Scottrade for asset or wire transfers.[26]

The problem, again, is that a corrupt investment adviser could simply forge the disbursement request. It happens more than you might imagine.

In 2005, the NYSE found that Schwab failed to prevent independent investment advisers from forging checks and letters of authorization to move its customers' assets and slapped the broker-dealer with a $1 million fine.[27] The non-employee advisers took advantage of Schwab's ineffective procedures to commit the fraud.[28] Schwab allowed the fraud to take place by failing to compare client signatures to original account documents on letters of authorization and wire requests to third-parties and failed to send confirmations directly to the customer when assets were transferred to parties other than the person on the account.[29]

More recently, in March 2016, the Texas State Securities Board reprimanded Scottrade and fined the firm $100,000 for supervisory violations of its independent investment advisers through the Scottrade Advisory Services platform.[30] The Board noted that: "[a]t all relevant times, broker-dealers such as Respondent were subject to securities regulations requiring firms to establish procedures designed to review and monitor the transmittal of customer funds by wire to third-party accounts."[31] However, the Board found that Scottrade "did not provide customers with a contemporaneous notification that customer funds had been transferred via wire from the customer's account to a third-party."[32] A copy of the Texas Disciplinary Order against Scottrade is attached as Appendix C. Obviously, wire transfer protocol should be heightened when firms deal with independent investment advisers for the simple reason that the requests emanate not from the investors

26. Scottrade, *Investment Advisor Limited Trading and Fee Authorization,*(2009) *available at* http://avondaleam.com/wp-content/uploads/2013/11/4-Investment-Advisor-Authorization.pdf.

27. *See* Div. of Enforcement v. Charles Schwab & Co., NYSE Decision 05-110 (Oct. 17, 2005), *available at* https://www.nyse.com/publicdocs/nyse/markets/nyse/disciplinary-actions/2005/05-110.pdf.

28. *Id.*

29. *Id.*

30. *See In re* Scottrade, Inc., Tex. St. Sec. Bd. Order No. IC16-CAF-04, *available at* https://www.ssb.texas.gov/sites/default/files/files/news/Scottrade_IC16-CAF-04.pdf.

31. *Id.*

32. *Id.*

themselves but from the investment advisers, thereby allowing for the opportunity of forgery. Forgery of client signatures is a particular problem when the clients have no notice that a disbursement of funds has taken place.

Management and Performance Fees

Invariably, when a third-party advisory account is opened at an online firm, the agreements between the adviser and the firm and the firm and the investor authorize the payment of management or performance fees directly out of the investor's account.

The firms are adept at attempting to protect themselves by inserting language in their agreements to protect themselves. Scottrade's Investment Adviser Limited Trading and Advisory Fee Authorization states as follows:

> I acknowledge that Scottrade is not responsible for monitoring or enforcing any advisory fee agreement between me and my Adviser. I also acknowledge that Scottrade is not involved in determining the amount of any fees and is not liable for any errors or miscalculations in the fee amount represented on the invoice.

The majority of third-party, individual accounts these days are managed on an annual fee based contractual arrangement. Generally speaking, those fees range from 1% to 2% based on the annual or quarterly net asset value of the account. Rarely do these arrangements cause problems.

Where the problems often do arise is in the performance fees. Some of the larger and more successful money managers charge a management fee as mentioned above and also charge a performance or incentive fee. This is the standard practice in hedge funds. The fee's methodology of calculation is spelled out in the various customer agreements, but the calculations of performance fees can be complicated and confusing. For example, the fulcrum fee is based on the asset value of the funds over a "specified period" and must increase or decrease proportionately with the "investment performance" of funds under management in relation to an "appropriate index of securities prices."[33] The inherent complexity of calculating performance fees can provide an opportunity for fraud by the dishonest investment manager who is the only one performing these complicated calculations on the accounts, without any supervision by the broker-dealer.

33. Investment Adviser's Act, 15 U.S.C. § 80b-5(b) (2012).

Our suggestion is that firms not be permitted to distribute funds directly to investment advisers, especially when the fee is either a performance fee or not monitored by the firm. Most all brokerage firms, including online firms, have separate departments that allow their brokers to become fee-based investment advisers. The NASD, now FINRA, has been regulating brokerage firms who allow their brokers to become registered investment advisers since 1994 when it clarified that firms must supervise securities transactions conducted by RR/IAs away from the NASD members with which they are associated.[34] Accordingly, firms already have systems in place to monitor their in-house investment advisers. You can bet that in those fee-based accounts, the firm is monitoring, calculating and double checking the management and performance fees of those accounts. It is not a huge leap to bring under the supervision umbrella the accounts of third party investment advisers.

Moreover, firms should have policies and procedures to monitor the management and performance fees charged by investment advisers to a) ensure that the charges comport with the agreement with the clients, and b) ensure that the charges do not exceed industry standards. That was the finding of the Texas State Securities Board's Order against Ameritrade in 2007, attached as Appendix D, wherein the Board was critical of the firm for failing to have written procedures to address the monitoring of independent third-party adviser fees:

> Until on or about April 4, 2006, Respondent had not established a system or any procedures reasonably designed to monitor for, and address, management fee transfer requests that could be in excess of the industry standards for management fees or otherwise indicative of improper conduct by an IIA on Respondent's trading platform.[35]

Texas recognized in the above finding that the charging of improper fees could be indicative of other improper conduct, prompting further investigation by the firm.

Supervision

It is significant that what the Texas State Securities Board used to find liability on the part of Ameritrade in the attached Appendix D was its own

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34. FINRA, NOTICE TO MEMBERS 94-44 (1994).

35. *See In re* Ameritrade, Inc., Tex. St. Sec. Bd. Order No. IC07-CAF-03, *available at* https://www.ssb.texas.gov/sites/default/files/files/news/IC07-03.pdf.

regulation which states that "a dealer shall establish, maintain, and enforce written procedures to supervise the activities of its agents that are reasonably designed to achieve compliance with the Texas Securities Act and Board Rules."[36] This rule is not so very different from FINRA Rule 3110, the Supervision Rule, which requires each member to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages…."[37] FINRA's supervision rule is actually broader than the Texas supervision rule, because it does not use the phrase "its agents," thereby allowing firms to argue that the independent investment advisors trading on their platform are not agents of the firm. The Texas State Securities Board didn't buy that argument if Ameritrade made it. The language of the FINRA Supervision Rule is perfectly worded so as to capture all of the wrongdoing that we are critical of in this article.

The broker-dealers, in particular the online firms, realized years ago that offering a trading platform to independent investment advisers was big business. So much so that each firm established divisions within their firms to handle this new business they often call "Advisor Services." The firms market these independent advisers with claims of name recognition of the firm, sophisticated trading platforms, etc.

While it would be great if FINRA issued a Regulatory Notice called "FINRA Clarifies Firm Duties with Respect to Independent Investment Adviser Accounts," it is not necessary. By virtue of having created platforms designed for use by investments advisers, broker-dealers have triggered the application of FINRA Rule 3110. Online/internet firms have already been sanctioned by state regulators for failing to have the proper procedures in place to protect the clients of these independent investment advisers. FINRA needs to follow suit; it has the ability to reign in the misconduct occurring in accounts managed by third-party investment advisers by simply enforcing Rule 3110. Broker-dealers, both brick-and-mortar and online/internet firms, must have in place policies to supervise the advisory businesses that they have embraced as a new business platform.

It must be remembered that when an independent, third-party adviser approaches an online broker-dealer, or even a brick-and-mortar broker-dealer, and seeks to open multiple accounts and manage them as the agent for those clients, the firm enters into a contractual relationship with that third-party

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36. Citing § 115.10(b)(1) of the Rules and Regulations of the Texas State Securities Board, 7 TEX. ADMIN. CODE § 115.10(b)(1) (2007).

37. FINRA, RULE 3110(b)(1) (2015).

investment adviser. That contractual relationship gives rise to supervisory responsibilities.

The New, New Account Forms, Hear No Evil See No Evil

Discussed earlier is the regulatory requirement of the broker-dealers to "Know Your Customer." This regulation, in combination with the regulations relating to books and records, requires broker-dealers to not only know the essential facts about their clients, but they are required to document what they know. This information is classically put on what we often refer to as the "new account form."

A number of the internet broker-dealers in just the last few years have changed their new account forms to no longer ask some of the basic, rudimentary information about the client, like investment experience, investment objectives, and risk tolerance. Surprisingly, we have seen this not only in the improperly coded "institutional" accounts, but also in regular accounts. The authors are not aware of any regulation or NTM or Regulatory Notice that states that internet broker-dealers are no longer required to obtain this information. In our minds, it is a direct violation of the "Know Your Customer" rule, and there is no "institutional" exception to the "Know Your Customer" FINRA Rule 2090.

But the argument in defense of the internet broker-dealers is merely, "under Notice to Members 01-23, we have no suitability obligations for unsolicited trades, so why do we need information that pertains purely to suitability?" This argument may have more resonance when there is a third party POA who (it may be argued) should obtain that information, not the firm.

However, specific circumstances give rise to specific "Know Your Customer" information-gathering requirements that are not so easily evaded:

Margin – The "No Duty" and the "Know Your Customer" defenses by the internet brokerage firms fail when it comes to the issue of margin. Even if you buy the argument that the margin rules were written to protect the brokerage firms, instead of protecting the clients, the regulations still require that BDs obtain and document certain financial information before they can allow an investor to use margin in their account.[38] Since each firm may have

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38. "Purchasing securities on margin in customer accounts without customer approval violates the anti-fraud provisions of the securities laws." *In re* J. Stephen Stout, Exchange Act Release No. 43410, 12 (Oct. 4, 2000). Margin is "a sophisticated tool" which may be wholly inappropriate for an account; *see* Timoleon

different financial requirements, the authority for this requirement is found in each firm's operations and compliance manuals.

Options – When it comes to options, the online brokerage firms' defenses fail even more so than with margin. FINRA's Option Rule 2360 states, "[i]n approving a customer's account for options trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives."[39] Another reason FINRA should revert back to "due diligence" instead of the watered-down "reasonable diligence" in the current suitability rule is so that it will be consistent with the options rule. The option rule makes no distinction for unsolicited trades and no distinction for online/internet broker-dealers. Additionally, the Chicago Board of Options Exchange (CBOE) has its own detailed set of regulations that apply to each and every BD (a point that internet/online broker-dealers love to ignore) dealing with options. It includes strict requirements as to knowing the customer, including detailed documentation of option experience and knowledge, as well as compliance and supervision which specifically includes monitoring the accounts.[40] And again, these regulations are not watered-down if the account is going to be managed by a POA.

Recommendations for Regulators

The following are some of our recommendations to fix the problems we have outlined in this article in power of attorney accounts:

- Annual renewal of all power of attorney agreements;
- Ban any use of "standing letters of authority" in POA accounts;
- Ban the use of "negative consent letters" in POA accounts;
- Provide contemporaneous confirmation to account owner of all disbursements out of the account;
- Require that opening account documents to be signed by the account owner be witnessed or notarized;

Nicholaou v. S.E.C., Fed. Sec. L. Rep. (CCH) ¶ 99,204, 51 S.E.C. 1215, 1217 (1994) (salesperson's improper use of margin in customer's account violated just and equitable principles of trade), *aff'd*, No. 94-3990, 1996 WL 140339 (6th Cir. Mar. 27, 1996).

39. FINRA, RULE 2360 (2014).

40. *See* CBOE, RULES 9.1-9.25(2010) (Doing Business with the Public).

- Option risk disclosure brochure and margin disclosure documents be sent directly to account owners and require a written signed acknowledgment of receipt by account owner;
- Require a notarized signature on any document granting limited trading authority;
- Require a bank medallion signature on any document granting full power of attorney;
- Disallow policies that allow broker-dealers to not send confirmations and monthly statements to the account owner;
- Stop the "Institutional Game" and do not allow BDs to designate an account institutional when an individual with less than $50 million in assets is the account owner;
- Wherever FINRA replaced the words "due diligence" with "reasonable diligence," put back the words "due diligence." "Due diligence" is a better defined legal and regulatory term, whereas "reasonable diligence" is too amorphous a term. Also, reverting back to "due diligence" will be consistent with FINRA Rule 2360's use of the term "due diligence" (FINRA's option rule);
- Require all BDs to conduct due diligence to know their customer and to document this knowledge on account forms which should be updated every three years. And even if it is anticipated that all of the trading and investment activity is going to be unsolicited, or managed by a third-party/POA, to document the client's age, profession, investment knowledge, investment experience, investment objectives and risk tolerance;
- Require documented, extensive due diligence on any person holding a POA;
- Require BDs, when dealing with an independent investment adviser, to obtain and document the information that we list in the section of this article titled, "Know Your Customer *and* The Power of Attorney";
- BDs should be required to make account holders aware of the results of the firm's due diligence and all material facts regarding the POA;
- Require that the due diligence on any person with a POA be updated at least every three years;
- Require special attention to the account where the adviser is getting a percentage of profits, because the incentive for abuse is so much higher;
- Require BDs to use the same screens and monitoring systems for POAs that are used for other supervised accounts;

- Create and require special screening and monitoring systems for POA accounts that would include such things as numerous accounts losing equity, contrary to a general bull market;
- Forbid BDs from allowing advisers to take their fees of any kind directly from the accounts at the brokerage firms. Advisers should submit their bills directly to their clients, and be paid directly by their clients and not through their brokerage accounts. An exception could be that if the BD is going to allow account withdrawals by the adviser, the BD must have a written, approved document stating specifically the details of how any fees or performance fees will be charged and it must monitor the account to make sure that the specifics of the fee-based arrangement are being met and complied with;
- Require BDs to send a copy to the account owner of every single document related to the account. Electronic format is acceptable. Do not allow any document of any kind to go only to the POA;
- Restrict BDs from granting POAs to non-family individuals who are not licensed (exceptions may apply to court appointed conservators or guardians). Additionally, friends should not be granted a POA unless they are licensed;
- Require BDs to notify account owners of all margin calls, margin call extensions, margin call forced liquidations. And require a direct phone call communication verifying that the account owner has received and understands the seriousness of margin calls; and
- Require BDs to notify the account owner in writing of any red flags or material issues that the BD uncovers in its due diligence investigation of the POA throughout the life of the account.

In addition, broker-dealers should be required to quarterly or annually send an activity letter to the account owner of a POA account that in plain language spells out a few facts:

1. The performance in dollars and percentages;
2. The performance in comparison to certain bench marks and indexes;
3. The activity in number of trades, dollars in and out, and the disclosure that active trading causes higher costs and taxes;
4. If options are used, a disclosure that options have higher costs and higher risks;
5. If margin is used, provide a full explanation in easy to read language of the conflicts, costs and higher risks; and
6. Total cost in commissions, fees, performance fees annualized and as a percentage of assets.