# NASAA Legislative Agenda
for the 113th Congress

**March 5, 2013**

**North American Securities Administrators Association | www.nasaa.org**

## Executive Summary

### To help Main Street investors and the nation recover from the recession and financial crisis, NASAA urges the 113th Congress to focus its oversight and legislative energies on efforts to promote sustained investor confidence in U.S. capital markets.

- ***To promote market accountability,*** Congress should pass legislation that would increase the civil monetary penalties the SEC may seek by linking the size of penalties to the amount of harm and investor losses, and establish a private right of action for aiding and abetting violations of the federal securities laws. In addition, Congress should enact legislation empowering states to provide investors with choices for dispute resolution, and increasing resources devoted to protecting older investors. NASAA further urges Congress to amend federal laws governing securities litigation to ensure that all investors, especially those investing small amounts, have a reasonable avenue to seek recovery.

- ***To promote greater transparency and systemic stability, and to reduce market volatility,*** NASAA urges Congress to enact legislation to increase information available to retail investors, including amendment of the Sarbanes-Oxley Act to make PCAOB disciplinary proceedings open to the public. NASAA encourages Congress to carefully investigate and scrutinize opaque market activities, including those of "dark pools," hedge funds and high-frequency trading. In this regard, Congress should level the playing field among market participants to ensure that access to information by sophisticated and speculative investors does not unfairly disadvantage or harm retail investors.

- ***To ensure investor protection provisions of Dodd-Frank are implemented,*** NASAA opposes legislation that would impose excessive regulatory analytical requirements on independent federal agencies engaged in rulemaking. NASAA appreciates the importance of efficient regulation; however, unreasonable regulatory requirements may have the deleterious effect of weakening vital federal investor protections. Bills which mandate numerous new cost-benefit analyses, or which vest regulatory analytical authority over independent agency rules with the White House Office of Management and Budget, could fracture the SEC's capacity to regulate securities markets and protect the investing public.

- ***To ensure all investors are protected when receiving individualized investment advice,*** NASAA opposes legislation that would authorize the SEC to designate an SRO for investment advisers. Rather than outsourcing responsibility for investment adviser oversight, Congress should provide the SEC with sufficient resources to examine all federally registered investment advisers. Accordingly, NASAA calls on Congress to enact legislation authorizing the SEC's Office of Compliance Inspections and Examinations to collect user fees from the investment advisers it examines. NASAA further urges Congress and the SEC to expand the fiduciary standard of care currently applicable to investment advisers to broker-dealers who provide personalized investment advice.

- ***To provide the strongest protection for Main Street investors,*** NASAA urges Congress to refrain from any further preemption of state investor protection authority. Moreover, to ensure that "mom and pop" investors do not assume disproportionate investment risk, state securities regulators support policies that allow investors to invest in small businesses, including emerging businesses, provided they understand the risk involved and have the financial ability to absorb attendant losses.

**TABLE OF CONTENTS**

**Core Principle One:** Promote Sustained Investor Confidence by Ensuring Market Transparency, Enhancing Investor Education, and Imposing Strong Penalties

- Congress Should Strive to Achieve Market Transparency and Level the Playing Field for Investors
- Congress Should Strengthen Penalties For Securities Law Violations
- Congress Should Strengthen Private Remedies for Victims of Fraud
- Congress Should Increase Resources Dedicated to Protecting Seniors and Other Vulnerable Americans

**Core Principle Two:** Policies Intended to Spur Capital Formation Must Balance the Need to Maintain Investor Protection

- Congress Must Strengthen Investor Protections that Were Weakened by the JOBS Act to Minimize the Act's Enormous Potential for Abuse
- Congress Should Mandate the Filing of Form D in Private Securities Offerings Exempt from Registration Under Rule 506
- Congress Should Amend the Securities Exchange Act of 1934 to Allow for a Private Civil Action Against a Person that Provides Substantial Assistance in Violation of Such Act

**Core Principle Three:** Support Strong and Complete Implementation of Investor Protections in the Dodd-Frank Act by the Conclusion of the 113th Congress

- Congress Should Urge the SEC to Impose a Uniform Fiduciary Standard on Financial Professionals Who Offer Personalized Investment Advice
- Implementation of Investor Protection Provisions in the Dodd-Frank Act Must Not be Subject to Redundant Regulatory Analyses Requirements
- Congress Should Take Steps to Improve the Fairness of the Securities Arbitration Process
- Congress Should Increase the Transparency of PCAOB Disciplinary Hearings and Related Proceedings

**Core Principle Four:** Regulation is an Inherently Public Function that Should be Performed by Government Regulators, not Outsourced to an Industry Self-Regulatory Organization

- Congress Should Authorize the SEC to Assess "User-Fees" to Fund Improved Oversight of Federally Registered Investment Advisers
- NASAA Vigorously Opposes the Creation of an SRO for State-Regulated Investment Advisers

**Core Principle Five:** State Authority Should Not Be Preempted, and Should Instead Be Expanded

- Congress Should Defer to the States in Prescribing Policies to Regulate Small Offerings, Which States are Most Capable of Policing
- States Must be Permitted to Preserve and Improve their Capacity to Undertake Coordinated Action when Circumstances Require Uniformity

## Core Principle One: Promote Sustained Investor Confidence by Ensuring Market Transparency, Enhancing Investor Education, and Imposing Strong Penalties

Trust in the financial markets is one of America's greatest competitive advantages, drawing capital investment to businesses and creating a robust economic system that is fair to all. The financial crisis and numerous recent scandals involving Ponzi schemes, insider trading and market manipulation have shaken investor confidence. NASAA considers it imperative that the 113th Congress take decisive steps to bolster market confidence and thereby lay a foundation for sustained economic growth.

- **Congress Should Strive to Achieve Market Transparency and Level the Playing Field for Investors**

The statutory and regulatory framework for the offer, sale and purchase of securities is designed to enhance investor confidence through full disclosure. Informed investors promote confidence in the market through discerning investment decisions.

Recent years have seen the proliferation of new and complex financial products in the global marketplace. As more complicated securities products enter the market, transparency regarding these products is critical, as both a means of deterring fraud and as a way to help ensure that investors do not assume inappropriate risk. For markets to rationally respond to these new products, full disclosure and transparency are essential.

NASAA believes that transparency makes markets more efficient and reduces opportunities for market manipulation and other types of investor abuse. Accordingly, NASAA will work with the 113th Congress to promote greater market transparency.

- **Congress Should Investigate and Scrutinize Opaque Market Activities, Including those of "Dark Pools," Hedge Funds, and High-Frequency Trading**

State securities regulators are concerned that advances in technology and other factors have made it increasingly possible for sophisticated market participants—hedge funds, dark pools, high-frequency traders, and others—to identify and exploit informational asymmetries in order to maximize profits, often at the expense of retail investors. In the wake of the 2010 "Flash Crash," the BATS IPO and the Knight Capital "fat finger" incident, it has become apparent that U.S. securities markets are experiencing unprecedented volatility, which has yet to be satisfactorily explained.

Main Street investors have the right to know what factors are driving this volatility, and what, if anything, financial regulators are doing to protect them from its potentially harmful effects. Congress has the authority to investigate opaque market actors, and NASAA urges Congress to make full and expeditious use of this authority to bring greater transparency to these areas. The investing public should be able to understand the nature of this phenomenon and judge its risk.

NASAA urges the 113th Congress to carefully investigate and scrutinize opaque market activities. One market phenomenon that is of particular concern to state securities regulators is High-Frequency Trading (HFT), which refers to the use of powerful computers to buy and sell enormous amounts of securities at incredibly high speeds. HFT appears to have potentially dangerous implications for ordinary "mom and pop" investors. [1] In this regard, Congress' goal should be to level the playing field among market participants by ensuring that access to information and activities by sophisticated and speculative investors do not unfairly disadvantage or harm retail investors.

- **Congress Should Strengthen Penalties For Securities Law Violations**

The economic recession and turmoil of the last half-decade was caused in significant measure by fraudulent financial activity. Widespread mortgage fraud, unscrupulous fixed-income departments, and accounting fakery all contributed to the financial meltdown. Fraud destroys trust in the financial system, while fairness and integrity build it.

For enforcement to be an effective deterrent, there must be a real risk of punishment for any brokerage firm or bank that misleads investors or otherwise perpetrates fraud and abuse. Scandals involving securities transactions undermine investor confidence, whether they arise in the form of insider trading, misrepresentations in connection with securities offerings, self-dealing through undisclosed related party transactions or other methods. Aggressive administrative, civil and criminal enforcement activities—including efforts to deter wrongdoing, to disgorge ill-gotten gains from wrongdoers, and, where possible, to provide restitution for aggrieved investors—is the only proven antidote.

In the 112th Congress, NASAA supported The Stronger Enforcement of Civil Penalties Act,[2] sponsored by Senators Jack Reed (D-RI) and Charles Grassley (R-IA), which would have increased the monetary penalties in administrative and civil actions involving securities law violations. It also substantially raised the financial stakes for repeat offenders, and linked penalties to the scope of harm and associated investor losses. In the 113th Congress, NASAA will intensify its efforts to secure the enactment of this or similar legislation.

- **Congress Should Strengthen Private Remedies for Victims of Fraud**

Congressional action to extend private remedies to victims of securities fraud is particularly urgent in light of SEC Chairman Elisse Walter's announcement on January 18, 2013, that the SEC will soon proceed with rulemakings to implement the Jumpstart Our Business Startups Act (JOBS Act), which will legalize equity "crowdfunding" and allow the advertising of private placements.[3] The JOBS Act will greatly increase the number of small investments in small, private companies. As a result, a single instance of fraud might easily result in damages to a large number of people. At the same time, however, the losses may be small enough that a private legal action by a single victim is not economically feasible.

To ensure that victims of securities fraud will have recourse, NASAA urges the 113th Congress to explore amending federal law to ensure that all investors, especially those investing small amounts, have a reasonable avenue to seek recovery. Failure to provide recourse to defrauded investors may have a chilling effect on future investment in these offerings and capital raising efforts generally.

While NASAA remains committed to ensuring that arbitration forums and procedures create an even playing field, NASAA also believes that arbitration should not be the sole forum available to aggrieved investors. Aggrieved investors should be able to seek relief in any forum and not be forced into an expensive arbitration that could foreclose the ability to obtain relief. Accordingly, state securities regulators urge the 113th Congress to take steps to ensure that private remedies for securities frauds are strengthened and expanded.

- **Congress Should Increase Resources Dedicated to Protecting Seniors and Other Vulnerable Americans**

A robust statutory framework for investor protection is critical to protecting seniors and other vulnerable citizens who are routinely targeted by predatory con artists. Shockingly, 1 out of 5 Americans over the age of 65 has been a victim of financial exploitation, and the problem is growing.[4] To combat such senior exploitation, the states have banded together to develop innovative fraud prevention programs and to cooperate closely on major fraud investigations. State securities regulators encourage the 113th Congress to do its part by increasing resources and tools dedicated to protecting seniors and other vulnerable citizens.

One important way that Congress can provide greater protection for seniors is by enhancing and refining the penalties for those who defraud them. In the 111th and 112th Congress, NASAA supported The Senior Investor Protection Enhancement Act,[5] which sought to impose higher penalties on those who target seniors with abusive sales practices. In the 113th Congress, NASAA will continue to push for enactment of this important legislation.

NASAA also intends to call on Congress to fund the Senior Investor Protection grant program to be established by the Office of Financial Education at the Consumer Financial Protection Bureau. The purpose of this program, which was authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), is to provide grants to states to fund additional resources, education materials and staff dedicated to cracking down on meaningless titles used by unscrupulous investment professionals to mislead investors about their expertise in senior financial issues. State securities regulators strongly supported its passage and will work to see that the annual authorization for these grants is funded by Congress.

Finally, in order to provide greater protection to seniors and other vulnerable Americans, Congress should not compromise investor protections in its efforts to expand

privacy protections for users of social and digital media. As Congress considers updating the 1986 Electronic Communications Privacy Act to refine and expand privacy protections for Americans in the age of social media, NASAA will work with members of the House and Senate Judiciary Committees to ensure that any such legislation does not inadvertently compromise investor protections, including the obligation of securities firms to supervise, record, and maintain business-related communications as required by regulators. Securities firms must be able to access social and digital media accounts involving business communications; otherwise, firms may not be able to detect serious problems that put consumers at risk, including misleading claims by an employee; insider trading, Ponzi schemes and other fraudulent activity; and inappropriate conduct such as the selling of investment products that the firm has not approved.

## Core Principle Two: Policies Intended to Spur Capital Formation Must Balance the Need to Maintain Investor Protection

The facilitation of access to capital for new and small businesses is a worthy goal. Small businesses, including startups with high growth potential, continue to have difficulty obtaining access to capital, and policymakers are justified in exploring new and innovative ways to help them. However, if Congress legislates in this area, it is imperative that it do so in a careful and deliberate fashion that balances the goals of capital formation with investor protection.

State securities regulators support the idea that the opportunity to invest in small businesses, including emerging businesses, should exist for all investors as long as they understand the risk involved and have the financial ability to absorb attendant losses. However, small and emerging businesses, by definition, carry extreme risk, and it is very difficult for most retail investors to evaluate or price this risk. Indeed, statistics show that roughly 50 percent of small businesses fail within the first five years.[6] Moreover, within this risky sector of small business investment, start-up businesses without a track record are particularly speculative and subject to failure.

If efforts to promote access to investment capital for small businesses are to be successful, investors need to be confident that they are protected to the fullest extent possible from fraud and undisclosed risk. Such assurance encourages investment, and in turn, increases the availability of investment capital. Conversely, hasty and ill-considered deregulation of public securities offerings, even when undertaken with the best intentions, can have devastating consequences for investors and businesses alike. In the absence of adequate attention to investor protection, policies that are intended to aid small businesses by helping them attract capital are likely to have precisely the opposite effect.

- **Congress Must Strengthen Investor Protections that Were Weakened by the JOBS Act to Minimize the Act's Enormous Potential for Abuse**

The 112th Congress passed the JOBS Act in an effort to make it easier for small and emerging companies to raise capital and grow. In doing so, many Members of Congress

expressed concern about the deterioration of long-standing investor protections. The 113th Congress should take steps to enhance investor protections; otherwise, investors will distrust the market, and the intent to increase capital for small businesses will be thwarted.

The removal of the ban on "general solicitation" in offerings conducted under Rule 506, as mandated in Title II of the JOBS Act, dismantles an important investor protection. NASAA believes that elimination of the ban warrants a corresponding increase in dollar thresholds in the accredited investor definition, and that Congress should mandate such a change. Congress also should ensure that clear guidance is given to issuers regarding the reasonable steps that are necessary to verify that purchasers are accredited investors. In addition, a Form D should be filed prior to the use of any general solicitation, and reasonable restrictions should be placed on advertising, including performance advertising for private funds.

SEC rulemaking on crowdfunding offerings, as authorized under Title III of the JOBS Act, should similarly reflect a uniform and balanced regulatory approach. For crowdfunding to be successful, regulations must create a framework that minimizes unnecessary burdens on small businesses while simultaneously insulating investors from fraud and abuse. Given the potential for huge numbers of unsophisticated investors to participate in crowdfunded offerings, and in view of the anticipated lack of regulatory oversight these public offerings will receive, NASAA believes that high standards must be in place for issuers and funding portals or intermediaries.

- **Congress Should Mandate the Filing of Form D in Private Securities Offerings Exempt from Registration Under Rule 506**

In Section 926 of the Dodd-Frank Act, Congress set forth a process to disqualify "felons and other bad actors" from conducting private securities offerings under Rule 506 of Regulation D. The adoption of a disqualification provision would provide much needed investor protection and would not be detrimental to legitimate issuers. Recidivists rightfully should not be allowed to conduct private securities offerings under the safe harbor exemption provided by Rule 506.

NASAA welcomes this change, especially after state regulators were preempted under the National Securities Markets Improvement Act (NSMIA) in 1996 from weeding out recidivists from Rule 506 offerings. In the post-NSMIA era, small business issuers are using Rule 506 almost exclusively for Regulation D offerings. Although properly used by many legitimate issuers, the exemption has become an attractive option for individuals who would otherwise be prohibited from engaging in the securities business. Today, the exemption is being misused to steal millions of dollars from investors through false and misleading representations in offerings that provide the appearance of legitimacy without any meaningful scrutiny of regulators. NASAA believes that Congress should require similar disqualification provisions to all other offerings made under Regulation D. This will assist states in keeping recidivists from selling securities to residents of their states.

Congress also can protect investors by requiring the filing of a Form D for each Rule 506 offering. Under current federal securities law, filing a Form D with the SEC and state securities regulators is not a condition to the availability of the Rule 506 exemption. In fact, because filing a Form D currently is not a condition of any Regulation D exemptions, it is hard for regulators and the public to use the filing or non-filing of a Form D as an indicator of securities law compliance. The fact that filing is not currently a condition of the exemptions at the federal level also creates confusion as to the necessity of filing with the SEC as well as the states and serves as a roadblock to enforcement efforts.

- **Congress Should Amend the Securities Exchange Act of 1934 to Allow for a Private Civil Action Against a Person that Provides Substantial Assistance in Violation of Such Act**

The 113th Congress should enact The Liability for Aiding and Abetting Securities Violations Act.[7] This important legislation, first proposed in 2009 by former Senator Arlen Specter and reintroduced in 2010 by Representative Maxine Waters, would amend the 1934 Act to establish a private right of action for aiding and abetting violations of federal securities laws.

Congress always has recognized private actions as a means of achieving the investor protection goals underlying securities laws. Private actions afford victims of fraud the best and often only hope of recovering their losses, which governmental enforcement programs are ill equipped to do on a large scale. By exposing all parties responsible for fraud, including those who provide substantial assistance, such legislation will not only help deter future violations, but may afford some recovery to those who have lost their investments and often their life savings.

Court cases have recently severely restricted aiding and abetting liability in private actions. These restrictions resulted from an overly narrow interpretation of the anti-fraud provisions set out by Congress. Where claims of fraud lie within the statutory boundaries set by Congress, there is no justification for such a narrow interpretation that further limits the ability of investors to seek relief.

Allowing private litigants to bring fraud claims against those who have aided and abetted such fraud will ensure that investors have meaningful private remedies in federal court. Given the marked rise in the incidence of corporate fraud and securities law violations affecting large classes of investors, the need for a partial legislative response is apparent. The balance has been tipped too far in favor of preventing claims rather than protecting investors who have suffered losses. Legislative action allowing federal relief is even more important in light of restrictions placed upon state law to provide an alternative remedy. In view of the massive corporate fraud that has surfaced in recent years, and because alternate forums for aggrieved investors remain limited, it is especially important that Congress provide meaningful remedies to victims of securities fraud.

## <u>Core Principle Three</u>: Support Strong and Complete Implementation of Investor Protections in the Dodd-Frank Act by the Conclusion of the 113th Congress

Full implementation of the investor protection provisions in the Dodd–Frank Act is one of the most important steps that the federal government can take to protect investors and promote confidence in U.S. capital markets. NASAA urges the SEC and other federal agencies to complete the Act's implementation prior to the conclusion of the 113th Congress, in January 2015, and to resist efforts to repeal the Act's reforms or impede their implementation. Specifically, NASAA supports provisions in the Act that increase state regulatory oversight of investment advisers; safeguard seniors from unqualified advisers; prevent securities law violators from conducting securities offerings under Regulation D; and authorize the SEC to mandate greater choice of forum and enhanced remedies for investors.

NASAA also strongly advocates provisions in the Act that empower the SEC to expand the fiduciary standard of care currently applicable to investment advisers to broker-dealers, who provide investment advice, as well as provisions designed to make capital markets more transparent by authorizing regulators to prescribe guidelines for certain structured products, limit speculative trading, and require that most derivatives be traded on exchanges. State securities regulators are particularly dedicated to swift adoption of policy reforms embodied in the Act that directly benefit retail investors.

- **Congress Should Urge the SEC to Impose a Uniform Fiduciary Standard on Financial Professionals Who Offer Personalized Investment Advice**

Section 913 of the Dodd-Frank Act (the 913 Study) directed the SEC to study differences in the standards of care required of broker-dealers and investment advisers who provide personalized investment advice. The 913 Study, which was completed in 2011, found that while investment advisers are subject to a strict "fiduciary duty" standard, broker-dealers are subject to more lenient standards governing their conduct. For example, in meeting their duty of loyalty, investment advisers cannot place their own interests ahead of those of their clients. Broker-dealers, however, are not subject to a similar constraint. To remedy this disparity, the Dodd-Frank Act empowered the SEC to harmonize the standards of care to require that all providers of financial advice to investors be true fiduciaries.

The establishment of a uniform fiduciary duty standard governing the conduct of broker-dealers and their agents is crucial for the protection of investors. Most investors cannot distinguish broker-dealers from investment advisers, nor do they understand the different legal standards applicable to either. As a result, many investors are unable to make informed decisions as to the best type of financial professional to retain. A fiduciary standard for broker-dealers will guarantee that *all* financial professionals providing investment advice will act in the best interests of their clients, and in turn, enhance investor confidence in the financial services industry and securities markets.

NASAA urges the SEC to pursue the course recommended by the 913 Study to subject broker-dealers to the same fiduciary duty standard currently applied to investment advisers when those brokers offer personalized investment advice to retail investors and other customers.

- **Implementation of Investor Protection Provisions in the Dodd-Frank Act Must Not be Subject to Redundant or Dilatory Regulatory Analyses Requirements**

In the two-and-a-half years since enactment, one of the potential obstacles emerging to successful implementation of the Dodd-Frank Act's investor protection provisions has been the use of regulatory analytical requirements to delay and frustrate the ability of regulators to promulgate rules under the Act.

Rulemaking processes to which the SEC and other federal regulators must adhere in implementing the Dodd-Frank Act are set forth in the Administrative Procedure Act (APA) and other statutes.[8] These processes require regulators engaged in rulemaking to perform economic and cost-benefit analyses of their proposed rules to "determine as best [as they] can the economic implications of the rule," and "examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choices made."[9] In addition to such mandates arising under the APA, the SEC has a unique additional obligation to consider the effect of a proposed rule upon "efficiency, competition, and capital formation."[10]

State securities regulators appreciate the importance of the rigorous regulatory analyses (*e.g.* cost-benefit and cost-effectiveness analyses) to which independent agency rules are subjected. However, NASAA is concerned that misuse of these analyses could severely impede the ability of independent federal agencies, such as the SEC, to implement important investor protections in the Dodd-Frank Act, as well as future laws designed to protect investors and the public.

NASAA was alarmed by the introduction of several legislative proposals in the 112th Congress that would create numerous new regulatory analytical hurdles for federal financial regulators charged with implementing the Dodd-Frank Act. As discussed above, their effect, if enacted, would be to derail implementation of important investor protections by delaying the Act's rulemakings indefinitely.

The 113th Congress must be vigilant in ensuring that dilatory or redundant regulatory analytical requirements are not successfully employed to delay or disrupt implementation of the Dodd-Frank Act and other important investor protection laws. To the extent that such analyses are appropriate, NASAA believes they should be performed expeditiously and by non-partisan experts within the agency in which Congress has vested rulemaking authority.

- **Congress Should Take Steps to Improve the Fairness of the Securities Arbitration Process**

Every year thousands of investors file complaints against their stockbrokers. Almost every broker-dealer presently includes in their customer agreements a mandatory pre-dispute arbitration provision that forces those investors to submit all disputes that they may have with the brokerage firm or its associated persons to mandatory arbitration. If cases are not settled, the only alternative is arbitration. For all practical purposes, the only arbitration forum available to investors is one administered by the Financial Industry Regulatory Authority (FINRA).

Section 921 of the Dodd-Frank Act provided the SEC with rulemaking authority to prohibit or impose conditions on the use of mandatory pre-dispute arbitration agreements if it determines it is in the interest of the public or investors. Pursuant to this provision, Congress should encourage the SEC to exercise its authority to propose or adopt rules prohibiting or conditioning pre-dispute agreements mandating arbitration.

In recent years, states also have seen the emergence of mandatory pre-dispute arbitration clauses in contracts between state-registered investment advisers and their clients, despite the fiduciary duty imposed upon investment advisers. In the 113th Congress, NASAA will seek legislation empowering state regulators to curtail the use of such clauses and to take the steps necessary to provide investors with a choice for dispute resolution.

- **Congress Should Increase the Transparency of PCAOB Disciplinary Hearings and Related Proceedings**

NASAA calls on the 113th Congress to pass The PCAOB Enforcement Transparency Act,[11] which would make public the disciplinary proceedings initiated by the Public Company Accounting Oversight Board (PCAOB) accounting firms and individual auditors.

The PCAOB was established by Congress to oversee auditors whose reports are filed with the SEC in order to protect investors and further the public interest in the preparation of informative, fair and independent audit reports on the financial statements of public companies. Adjudicatory proceedings to determine whether an auditor or audit firm should be sanctioned for violating applicable rules or standards are an important component of the PCAOB's oversight authority. However, unlike the disciplinary proceedings of other, comparable regulators, the PCAOB's cases are non-public until they are appealed to the SEC. The nonpublic nature of PCAOB disciplinary proceedings has serious adverse consequences for the investing public, audit committees, the auditing profession, the PCAOB and other interested parties. Congress should remedy this situation by amending the Sarbanes-Oxley Act so that the PCAOB disciplinary proceedings will be open to the public.

## <u>Core Principle Four</u>: Regulation of Investment Advisers is an Inherently Public Function that Should be Performed by Government Regulators, not Outsourced to an Industry Self-Regulatory Organization

Since the passage of NSMIA in 1996 and the Dodd-Frank Act in 2010, the division of federal and state regulatory responsibility over investment advisers has been clearly delineated according to the amount of investors' assets under management. NSMIA bifurcated regulatory responsibility between the states, which were given authority to oversee investment advisers with up to $25 million in assets, and the SEC, which oversaw all other investment advisers. In 2010, the Dodd-Frank Act acknowledged the important and successful role states play in investment adviser regulation and increased the states' regulatory responsibility by transferring to them oversight of mid-sized investment advisers—those with assets under management between $25 million and $100 million.

From the perspective of states securities regulators, this division of state and federal regulatory responsibility for investment advisers has worked very well. States have robust and dynamic regulatory oversight programs. States, unlike the SEC, regulate both investment advisers and investment adviser representatives. Almost every state performs on-site examinations, on a routine and for-cause basis, often using sophisticated examination modules. And the majority of states conduct examinations on average at least once every four years.[12]

In contrast to the states' experience regulating small and mid-sized investment advisers, in the post-NSMIA era, the SEC has struggled to adequately examine the large federally registered investment adviser firms for which it is responsible. The problems that exist with the SEC's oversight of federally registered investment advisers have been characterized as a "regulatory gap." NASAA recognizes that this gap places investors at risk, and strongly believes that Congress should address it by providing the SEC with the resources to do the job, or a mechanism to gain these resources, and not outsource the responsibility to an industry-funded self regulatory organization (SRO). NASAA urges the 113th Congress to reject proposals to establish additional SROs, and instead to enable federal regulators with the resources they need to effectively monitor the firms and representatives under their jurisdiction.

- **NASAA Vigorously Opposes the Creation of an SRO for State Regulated Investment Advisers**

When it comes to the regulation of investment advisers, government regulators have decades of experience that is unmatched by any other authority or entity. NASAA sees little benefit in constructing and imposing a new layer of bureaucracy, with its attendant, well-documented expenses. The goal is to strengthen investor protection by improving the oversight of SEC-regulated investment advisers, and the best way to do this is to adequately fund federal regulators.

The existing securities industry SRO model—as typified by FINRA—also lacks accountability and is replete with conflicts of interest. Even where there is an independent Board of Directors, SROs remain organizations built on the premise of self-rule and are, as a matter of first principle, accountable to their members, not the investing public. Indeed, the Section 914 of the Dodd-Frank Act study (the 914 Study) underscored this point when it noted that an SRO containing "industry representatives" in its governance structure could have an elevated vulnerability to industry capture.[13] No matter how many safeguards are instituted, an SRO lacks accountability and has substantial and inherent conflicts of interest that governmental regulators do not.

SROs also are more costly and inefficient than direct government oversight. For example, the establishment of an SRO for investment advisers would create a duplicative regulatory structure, with the SEC being responsible for the oversight of the SRO, and the SRO in turn being responsible for the oversight of investment advisers. Thus, establishing an SRO will likely be more expensive, both initially and over the long-term, than funding a more robust SEC to oversee the industry. Indeed, according to an independent analysis performed in 2011 by the Boston Consulting Group, the start-up costs of an SRO for investment advisers alone would be sufficient to fund an enhanced SEC examination program for an entire year.[14]

Finally, aside from structural concerns raised by legislation establishing an SRO for investment advisers, most state-registered investment advisers are small businesses employing only a few people. The majority of their clients are not wealthy individuals or institutions, but hard-working Americans trying to plan for retirement or their children's education. State securities regulators are extremely concerned about the impact that legislation requiring investment advisers to join an SRO would have on state-registered investment advisers and their clients. In short, any legislation that would require small and mid-sized investment advisers to join an SRO has the very real potential to be a job killer.

- **Congress Should Authorize the SEC to Assess "User-Fees" to Fund Improved Oversight of Federally Registered Investment Advisers**

State securities regulators continue to believe that best way for Congress to improve the oversight of federally registered investment advisers is to provide the SEC with the resources it needs to do the job. Unfortunately, the SEC still lacks the necessary funding to adequately oversee the investment advisers it regulates.

Recognizing current political realities, NASAA believes that the most efficacious way for Congress to improve the oversight of federally registered investment advisers is to enact legislation authorizing the SEC's Office of Compliance Inspections and Examinations (OCIE) to collect user fees from the investment advisers it examines. The revenue derived from such user fees, which would not come at any cost to taxpayers, could then be used by OCIE to fund additional examinations of federally registered investment advisers.

As a matter of efficiency and cost, authorizing the SEC to fund enhanced oversight of federally registered investment advisers through the imposition of user fees also makes more sense than establishing a new SRO for investment advisers. Specifically, imposing user fees would be a less expensive option because the SEC would not have to spend significant resources in overseeing an SRO. Indeed, the 914 Study acknowledged the high costs of coordination between the SEC staff and an SRO "which might include, for example, not only direct costs like additional management costs required to oversee the SRO's effectiveness, but also other costs that are even more difficult to quantify."[15]

The 914 Study's conclusion has been echoed by investment adviser firms and validated by independent analyses. For example, the study conducted by the Boston Consulting Group, referenced above, found that establishing an SRO for investment advisers would likely cost at least twice as much as funding an enhanced SEC examination program.[16] The same study found that the startup costs of an SRO alone ($200–310 million) could fund an enhanced SEC examination program for an entire year ($240–270 million).[17]

In the 112th Congress, NASAA was pleased to support The Investment Adviser Examination Improvement Act,[18] sponsored by Rep. Maxine Waters (D-CA), which would have authorized the SEC to assess user fees on investment advisers to fund an expansion of its adviser examinations. As revenue from the user fees contemplated by the bill would have been available to the SEC only to fund additional examinations of investment advisers, and not to subsidize other functions of the Commission, the proposed bill would have been highly cost-effective not only from the perspective of the government, but also from that of the investment adviser industry. In the 113th Congress, state securities regulators will continue to strongly support and advocate for the enactment of The Investment Adviser Examination Improvement Act or similar legislation.

## Core Principle Five: State Authority Should Not Be Preempted, and Should Instead be Expanded

As a matter of principle, NASAA ardently believes that Congress should refrain from preempting state law. For most investors, states are far-and-away the most responsive, accessible, and attuned regulators. Congress has recognized the performance and relevance of state securities regulators by expanding state responsibilities for the oversight of investment advisers and ensuring that state financial services regulators had a voice on the Financial Stability Oversight Council. Nevertheless, recent federal legislation has threatened to preempt the authority of the states.[19]

- **Congress Should Defer to the States in Prescribing Policies to Regulate Small Offerings, Which States are Most Capable of Policing**

State regulators are closest to the investing public and understand the complex challenges faced by small businesses seeking to raise capital. State regulators are members

of the communities they serve, and see first-hand how the public is optimally served by policies that strike a reasonable balance between the interests of issuers and investors.

Further, it is important to note that the SEC has neither the mandate nor the resources to police small offerings. Federal policies that vest rulemaking responsibilities exclusively with the SEC effectively separate the rulemaking from the enforcement responsibility. From a public policy standpoint, such arrangements are highly inefficient and sometimes dysfunctional.

Prior to the Dodd-Frank Act, consumer protection responsibilities had been spread across various federal banking regulatory agencies, with the Federal Reserve having sole authority to adopt rules to protect consumers from "unfair and deceptive practices," and individual prudential bank regulators like the Federal Deposit Insurance Corporation and the Comptroller of the Currency having the sole power to enforce those rules. This resulted in rulemakings that did not take into account lessons learned from enforcement actions and enforcement actions that were delayed due to a misunderstanding of regulations.

The bifurcation of rulemaking and enforcement authority that failed to protect consumers at the federal level in the years preceding the 2008 Financial Crisis is no more likely today to succeed in protecting investors from fraud in small offerings. Thus, in areas where state securities regulators are expected to initiate and perform virtually all enforcement activity, Congress also should permit the states to exercise rulemaking authority.

- **States Must be Permitted to Preserve and Improve their Capacity to Undertake Coordinated Action when Circumstances Require Uniformity**

With 52 independent jurisdictions in the U.S. and its territories, states operate with substantial and ever-increasing efficiency, and they have a strong track record of working together in a coordinated manner on a wide range of issues. Advances in technology have resulted in automation of the registration process for individuals and firms, and coordinated reviews for securities registrations and mid-size or regional investment advisory firm examinations are becoming the norm rather than the exception.

Regulatory efforts involving interstate misconduct are routinely coordinated nationally to leverage state resources and reduce the cost and burden to the businesses involved (e.g., in the cases of sales practice violations relating to Auction Rate Securities). The year 2012 saw the highly successful "Switch" of federally covered advisers to state registration. In 2008, NASAA adopted a model rule prohibiting deceptive senior-specific professional designations. Continuing to make progress in this area will be a high priority for state securities regulators as well as NASAA in the 113th Congress, and this progress should not be stultified by the threat of federal preemption.

[1] Andrew G. Haldane, Director of Financial Stability at the Bank of England. *Patience and Finance* (September 2, 2010), available at http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech445.pdf.

[2] S. 3416 in the 112th Congress.

[3] On January 18th SEC Chairman Elisse Walter informed members of the SEC's Investor Advisory Committee that the agency is moving forward in 2013 with the rulemaking mandated under the JOBS Act.

[4] National Center on Elder Abuse. Factsheet: Elder Abuse Prevalence and Incidence (2008), available at http://www.ncea.aoa.gov/main_site/pdf/publication/FinalStatistics050331.pdf.

[5] H.R. 774 in the 112th Congress.

[6] U.S. Small Business Administration, Office of Advocacy, "Frequently asked Questions," 2011, available at http://www.sba.gov/sites/default/files/sbfaq.pdf.

[7] H.R. 5042 in the 111th Congress.

[8] The National Environmental Protection Act (NEPA), the Regulatory Flexibility Act (RFA), the Congressional Review Act (CRA), and the Paperwork Reduction Act (PRA) set forth additional procedures that federal agencies must follow prior to finalizing a rule.

[9] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).

[10] 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c).

[11] S. 1907 in the 112th Congress.

[12] *State Investment Adviser Regulation Fact Sheet* (July, 2011). The referenced document was prepared by NASAA on the basis of June 2012 survey data and discussions with state securities regulators.

[13] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011) ("Section 914 Report").

[14] The Boston Consulting Group. *Investment Adviser Oversight: Economic Analysis of Options* (December, 2011), available at http://www.cfp.net/downloads/BCG_Investment_Adviser_Oversight_Economic_Analysis.pdf.

[15] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011) ("Section 914 Report").

[16] The Boston Consulting Group. *Investment Adviser Oversight: Economic Analysis of Options* (December, 2011), available at http://www.cfp.net/downloads/BCG_Investment_Adviser_Oversight_Economic_Analysis.pdf

[17] Id. at 5.

[18] H.R. 6204 in the 112th Congress.

[19] Several bills introduced in the 112th Congress sought to preempt state securities regulators, including most prominently the JOBS Act.