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North American Securities Administrators Association

2008 Pro-Investor Legislative Agenda

Preamble

For 88 years the North American Securities Administrators Association (NASAA) has worked on initiatives impacting state and federal legislation, rulemaking, and coordinated enforcement actions all with the common goal of protecting investors and maintaining investor confidence in our markets. NASAA is committed to continuing its venerable mission and to that end announces its legislative agenda for the second session of the 110th Congress. The items in this agenda fall into five broad categories: 1) Preserving the authority of state regulators to protect investors, and evaluating the negative effects of preemption of certain state laws; 2) Strengthening the mechanisms currently in place that provide redress to investors for wrongdoing by industry participants; 3) Maintaining federal laws designed to insure corporate accountability and shareholder confidence; 4) Promoting sound and effective regulatory initiatives; and, 5) Improving the scope and breadth of investor education efforts.

1. Support a Strong and Effective Regulatory Structure for Capital Markets.

As noted in the preamble, state securities regulators have a proud tradition of protecting investors. In their continued effort to accomplish this mission, state regulators will continue to vigorously defend their authority to regulate at the state level and bring enforcement actions seeking appropriate remedies against those firms and individuals that violate securities laws in their jurisdictions. NASAA members will remain vigilant in fighting attempts, such as the three Capital Markets Competitiveness Reports issued during the last year. Those three reports —“The Interim Report of the Committee on Capital Markets Regulation” (The Glenn Hubbard/Hal Scott Report), the “Commission on the Regulation of U.S. Capital Markets in the 21st Century” (The U.S. Chamber of Commerce Report) and “Sustaining New York’s and the U.S.’ Global Financial Services Leadership” (The Schumer/Bloomberg or McKinsey Report) seek to neutralize state regulators who aggressively protect investors, the bedrock of our market confidence. More recently, the Department of Treasury released its request for input as part of its “Review of the Regulatory Structure Associated with Financial Institutions,” and the Financial Services Roundtable released its “Blueprint for U.S. Financial Competitiveness.” The Blueprint calls for the creation of an optional national securities charter that would subject a firm to examination and enforcement by a single national regulatory authority and greatly weaken the states’ ability to uncover wrongdoing and maintain the integrity of the marketplace.

NASAA believes that the complementary state-federal-industry regulatory relationship has a proven record of serving investors well. In light of the recent consolidation of the NASD and NYSE Regulation into the Financial Industry Regulatory Authority (FINRA), the need for strong state securities regulatory authority is heightened. With more than 100 million investors relying on our securities markets to meet their financial goals – and on regulators to keep those markets well-policed – we must ensure that this successful and cooperative regulatory relationship remains as strong as possible and NASAA would support legislative initiatives designed to facilitate and strengthen this cooperation.

NASAA jurisdictions have a strong record of working cooperatively with fellow regulators, which NASAA believes are vital to effective and efficient regulation. The current level of collaboration is reflected by NASAA's participation in a joint national initiative with the SEC and FINRA to protect seniors from investment fraud and sales of unsuitable securities. These synergies serve as building blocks for other cooperative efforts. For instance, NASAA looks forward to working with the SEC as it continues to study the various regulatory schemes affecting both broker-dealers and investment advisers. NASAA also looks forward to strengthening its partnership with industry SROs especially in the area of public disclosure of information on the disciplinary history of industry participants.

2. Restore Fairness and Balance in the Securities Arbitration System.

Every year thousands of investors file complaints against their stockbrokers. If these disputes aren't settled, investors are left with only one avenue to pursue their claims – arbitration – and for all practical purposes only one arbitration forum. This system, which is administered by an affiliate of FINRA, should be examined to ensure it is fair and transparent to all.

During the first session of the 110th Congress, elected officials began to realize that the scales of justice had begun to tilt unevenly away from consumers. In an attempt to rectify this situation, S. 1782/H.R. 3010, the "Arbitration Fairness Act of 2007," was introduced. This proposal makes mandatory arbitration predispute agreements to arbitrate employment, consumer, franchise or civil rights disputes unenforceable. NASAA submitted a letter in support of the legislation and suggested that it be amended to clarify that its provisions extend to securities arbitration. In December 2007, NASAA testified before the U.S. Senate Committee on the Judiciary Constitution Subcommittee and recommended the enactment of S. 1782.

State securities regulators believe Congress should also review the manner in which arbitrations are conducted to determine if there is sufficient disclosure of potential conflicts by panel members; to determine if selection, qualification, and composition of the panels is fair to the parties; whether the arbitrators receive adequate training; if explanations of awards are sufficient; if the system is fast and economical for investors; and if the entire arbitration process should be optional, not mandatory, for investors.

3. Increase Sanctions for Crimes Against Senior Citizens.

Notwithstanding the multi-front offensive launched by state and federal securities regulators, senior citizens remain a target for unscrupulous scam artists. State securities regulators recently announced that 26 percent of all enforcement actions during 2004-2005 involved the financial exploitation of seniors. Preliminary results from our most recent survey show that the percentage of senior investor complaints has risen to 44 percent.

Investment fraud targeting seniors is an ongoing concern, and NASAA believes that Congress should explore proposals to assist law enforcement and prosecutors to ensure that those who take advantage of our nation's elderly will be held accountable. Fraudulent investment sales to seniors will remain a problem of epidemic proportions as long as the benefits to the perpetrators outweigh the costs. Enhanced penalties for senior abuse – ranging from fines to jail terms – should help to raise those costs, deter law violations and punish appropriately those who exploit senior investors.

In 2007, state securities regulators in Hawaii, with the assistance of AARP, recognized the importance of placing stricter penalties on those who target seniors with abusive sales tactics by supporting legislation that establishes additional securities violations when the act is directed against seniors (62 or older) to include imposing administrative penalties not to exceed \$50,000 and civil penalties not to exceed \$50,000 for each violation. At the federal level, NASAA will continue to work with members of Congress to prepare legislation that increases sanctions for crimes committed against seniors relating to securities fraud.

4. Define Equity Indexed Annuities as Securities.

The sale of equity-indexed annuities (EIAs) has risen dramatically since 1995, when they first appeared on the market. Estimates are that \$25 billion of these products were sold in 2005. This increase in sales volume has been driven largely by the high commissions that sales agents earn on EIAs. As financial media commentators have said repeatedly — these products are not bought but sold. Problems have arisen, however, because EIAs are extremely complex and they have a number of onerous features, including long accumulation periods and high surrender charges. State securities regulators, as well as the SEC and the SROs, are receiving an increasing number of complaints about EIAs.

Although EIAs may be legitimate investment vehicles for some people, NASAA is concerned that these products are unsuitable for many investors and that they are often associated with deceptive marketing tactics. Particularly troubling is the sale of EIAs to senior citizens, who are being aggressively targeted through investment seminars nationwide.

The status of EIAs as securities remains uncertain. The SEC first solicited public comment on the appropriate treatment of EIAs under federal securities law in 1997 but the agency has not yet issued guidance on the issue. FINRA has cautioned its members that EIAs may well constitute securities, depending upon the facts and circumstances in each case, and it requires member firms to follow special precautions when their associated persons sell EIAs, regardless of whether they are deemed to be securities.

NASAA believes that it is time to remove the legal uncertainty surrounding EIAs and that it is appropriate to classify these investment products as securities. This is conceptually sound under current law, at least in instances where EIAs are promoted and sold primarily as investments rather than insurance products. This is especially appropriate from the standpoint of investor protection, given the level of sales abuse associated with these products and the unique ability of securities regulators at both the state and federal level to address those abuses at the point of sale. The strong suitability standards found in the state and federal securities laws will help ensure that EIAs are sold only to investors for whom they are appropriate. The application of the securities laws to the sale of these products also will help ensure that investors receive complete, understandable, and accurate information regarding all material aspects of these products prior to purchase and that investors are afforded remedies if they are defrauded or harmed by other abusive sales practices.

5. Uphold State Role in Data Security Breach Protection.

As a result of both our enforcement and education efforts, state securities regulators have been made acutely aware of the investing public's concern with security of their personal data and protection from identity theft. Heightened congressional interest in security breach legislation follows the enactment of laws in a number of states requiring institutions to notify affected consumers following a data security breach. According to the National Conference of State Legislatures (NCSL), at least thirty-five states have enacted some form of data breach disclosure laws. These efforts by state legislatures have resulted in a heightened awareness by the general public of the deficiencies in the security of electronic information in general, and of numerous security breaches at some of the nation's largest firms and governmental agencies. Currently, state securities examiners are conducting examinations of not only investment advisers but also broker-dealers to ensure the privacy of persons who give them personal information in the course of doing business or considering doing business. NASAA wants to ensure our authority is not inadvertently preempted in a data security breach law.

The level of federal preemption in the various data security breach bills introduced during the first session of the 110th Congress varies from a narrowly focused preemption proposal to a near total preemption of state laws in the privacy area. Any federal bill dealing with data security breaches should preserve state laws that address problems surrounding data security. A state role is vital to effective consumer protection, and we strongly support a continuation of the enforcement role of the state attorneys general in this area.

In addition, should Congress decide to preempt certain state laws, high standards should be enacted in their place, including strong provisions for national security breach notification and when a consumer can impose a security freeze on access to his/her consumer credit report and credit score. Without such a strong federal substitute, consumers will be deprived of the protections that state laws currently provide.

6. Maintain Strong Investor Protection Provisions of the Sarbanes-Oxley Act (SOX).

Investors were right to be outraged by the frauds of Enron, WorldCom and others and Congress was right to pass tough corporate accountability legislation in response. The industry-created scandals of recent years caused Main Street investors to lose billions of dollars and gave our nation's corporate reputation a black eye in the world community. Legislation passed in response to these corporate debacles was appropriate.

While numerous capital market reports have been openly critical of certain SOX requirements, there has been no empirical evidence that suggests the U.S. capital markets have suffered as a result of these requirements. In fact, variations of the law's internal control reporting requirements are being adopted in Japan, France, China, Canada, and several other countries to improve the integrity of their financial reporting. NASAA continues to oppose changes to the fundamental principles of the Act, but recognizes that its regulatory requirements for small firms may require some modification.

7. Advance and Increase Financial Education Efforts.

The securities regulators that form the NASAA membership are firmly committed to promoting and supporting financial literacy, and are firmly committed to delivering investor education for all consumers. We believe we have an ongoing obligation to help our constituents develop the knowledge they need to make good personal financial decisions. NASAA members use a variety of channels to engage investors of all ages including presentations, exhibits, publications, and also new technology with NASAA's

podcast series, *The Alert Investor*, and the recently launched innovative online program *FSI: Fraud Scene Investigator*, which teaches students how to fight investment fraud firsthand.

The rising tide of baby boomers entering retirement also necessitates the need to educate seniors about investment fraud. Our seniors have the most to lose if victimized by investment fraud as they may have little time to re-coup their devastating losses. It remains our fundamental belief that financial education is the first and best defense against financial fraud, abuse, and exploitation. State securities agencies are leaders in grassroots investor outreach and education and look for opportunities to join forces with other members of the financial education community who also share a commitment to investor protection. NASAA urges Congress to fund programs to cultivate financial education partnerships among federal, state and nonprofit entities and encourage dialogue among these groups such as the newly created National Financial Education Network of the U.S. Treasury Department's Financial Literacy Education Commission (FLEC). NASAA continues to support Congressional efforts to designate April as Financial Literacy month and encourage events such as Financial Literacy Day on Capitol Hill.

8. Reinstate State Regulatory Authority of Regulation D 506 Offerings.

The scope of covered securities in Section 18(b) of the 1933 Act has expanded since the National Securities Markets Improvement Act of 1996 (NSMIA) was enacted, even though the definition has technically remained the same. More issuers are using Rule 506 and the listing standards on some of the exchanges are deteriorating, so more securities that fall within the definition of covered security are being offered to the public with little or no scrutiny.

Rule 506 of Regulation D offerings are provided the special status of private placements and are exempt from federal and state securities registration laws. As a result of this special status, there is no regulatory review of the 506 offerings at either the federal or state level. Thus, for example, NSMIA has preempted the states from prohibiting Regulation D offerings even where the promoters or broker-dealers have a criminal or disciplinary history. Some courts have even held that offerings made under the guise of Rule 506 are immune from scrutiny under state law, regardless of whether they actually comply with the requirements of the rule. As a result, state securities regulators have seen a transition of practically all Reg D offerings to Rule 506. If the SEC does not implement ineligibility provisions applicable to issuers making sales through bad actors, Congress should act to protect investors from recidivist violators who are currently free to participate in Rule 506 offerings.

In light of the growing popularity of the offering and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Regulation D offerings.

9. Update and Strengthen the Accredited Investor Definition.

The Securities and Exchange Commission proposed two rules that would require natural persons investing in hedge funds and other private funds that claim an exemption under 1940 Investment Company Act Section 3(c)(1) to meet additional financial criteria beyond the "accredited investor" standards. Specifically, the proposed rules would require that natural persons have "investments" of \$2.5 million (excluding personal residence and property used in a trade or business) and satisfy the current "accredited investor" standards. The SEC is still evaluating this proposal.

The current "accredited investor" standard is satisfied if a natural person has an individual net worth, or joint net worth with their spouse, of \$1,000,000 or if that person

has an individual income of \$200,000, or joint income with their spouse of \$300,000. Since this standard has remained unchanged since its adoption in 1982, inflation has rendered it meaningless. NASAA has long advocated for adjusting the definition of “accredited investor” in light of inflation and has expressed concern at the length of time the thresholds contained in the definition have not been adjusted. NASAA is encouraged that the Commission included revisions to the definition of accredited investor in recent proposed rulemaking to adjust for the effects of inflation on wealth and income, and to provide for adjustments on an ongoing basis. However, we are disappointed that the Commission’s proposal failed to adjust the current thresholds to account for the impact of inflation over the past 25 years and the first inflationary adjustment to the definition will not occur for another five years. NASAA will continue to comment on this issue, and believes the accredited investor standard should be revised in all its applications, rather than limited to investments in certain private funds.

Raising the standard for individual investors will provide greater protection for investors and will aid state regulators in enforcement activities by furthering the suitability determination for those individuals who choose to take greater risks. In order to insure that those representing themselves as “accredited investors” do in fact meet the definition, NASAA suggests implementing, either by rule or by statute, a requirement that industry participants be required to independently verify a potential investor’s representation that he or she meets the financial guidelines.

10. Encourage Hedge Fund Transparency and Pension Protection.

NASAA supports efforts to regulate hedge funds in a manner that will provide greater transparency to investors while not overburdening the hedge fund industry. With over 10,000 funds in existence and assets in excess of \$4 trillion, the fact that this industry remains, for the most part, unregulated is worrisome for investors and the U.S. markets in general.

ERISA rules make hedge funds and their managers “trustees” if more than 25% of the fund’s assets are pension assets. The Pension Protection Act of 2006 removed public pension funds from the 25% calculation. State securities regulators question the wisdom of this change and they believe this is an issue that should be closely monitored. State securities regulators want to ensure that public pension plan monies are not subject to undue risk through investment in unregulated pooled vehicles.

11. Preserve the Authority of State Securities Regulators.

The Gramm-Leach-Bliley Act (GLBA) affirmatively preserves the authority of the Securities and Exchange Commission and state securities regulators to investigate and bring enforcement actions with respect to fraud and deceit or unlawful conduct by any person when the activities are conducted in a functionally regulated subsidiary of a depository institution. Clearly, Congress understood weakening the authority of state regulators in this area would be harmful to investors.

Congress should undertake a review of recent activities by both the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC) for compliance with federal law. Specifically, these two agencies have in one instance promulgated rules and in another issued an opinion letter with sweeping preemption provisions, which have been upheld in several federal court decisions. Congress should consider adopting legislation that disapproves of such legislative-style activity by a few federal regulators and that expressly preserves the authority of state regulators to protect consumers from fraud and abuse in the banking and securities sectors.



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