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Before the

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“Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office"

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Chairman Frank, Ranking Member Bachus, Members of the Committee,

I am Denny Crawford, Texas Securities Commissioner and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I am honored to be here today to discuss legislative changes that are most relevant to the millions of Main Street Americans who are looking to lawmakers and state and federal regulators to help them rebuild and safeguard their financial security. At this critical time in the nation's history, it's imperative that our system of financial services regulation be improved to better protect investors, markets, and the economy as a whole. I commend the Financial Services Committee for its deliberative approach of holding comprehensive hearings to determine how best to improve our financial regulatory system.

In November 2008, NASAA released its *Core Principles for Regulatory Reform in Financial Services* and subsequently recommended a pro-investor legislative agenda for the 111th Congress. We are pleased that many of our proactive policy recommendations to better protect investors and restore confidence in our financial markets are now being debated as part of the broader regulatory reform agenda. Today, I would like to highlight the suggestions that we feel are most vital to sound regulatory reform and strong investor protection.

***State Securities Regulatory Overview***

The securities administrators in your states are responsible for enforcing state securities laws, the licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, pursuing cases of suspected investment fraud, and providing investor education programs and materials to

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others, like me, work for independent commissions or boards. We are often called the "local cops on the securities beat," and I believe that is an accurate characterization. While the recent financial crisis was the result of many failures, I am very proud to say that a failure of state securities regulation was not one of them.

Through the years, states have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious jail time for securities-related crimes. We have successfully exposed and addressed the profound conflicts of interest among Wall Street stock analysts by requiring changed behavior. We led all regulators on late trading and market timing in mutual funds. We address on a daily basis abusive sales practices targeting vulnerable senior investors.

State securities regulators continue to lead the effort to ensure that investors receive redemptions for their frozen auction rate securities that were marketed as safe and liquid investments, an effort that already has resulted in the largest return of funds to investors in history. In the last few years, it has been state securities regulators who have been at the forefront of investor protection. Our record demonstrates clearly that we have the will and ability to regulate.

***Investor Protection Act Initiatives***

The proposals set forth in the Obama Administration's Investor Protection Act ("IPA") and further enhanced in the Committee's October 1 "Discussion Draft" do much to improve investor protection and help restore confidence and integrity to our markets. Included in the Discussion Draft are provisions designed to facilitate communication and the sharing of information between the Securities and Exchange Commission ("SEC") and other regulators. The sharing of information among state and federal regulators is an important element in ensuring that investors are protected. Unfortunately, though, the sharing of information by the Financial Industry Regulatory Authority ("FINRA") with state and federal regulators has been less than optimal. Claiming that the sharing of information implicates "state actor" questions, FINRA regularly declines to share information with government regulators about examinations and investigations.

Because self-regulatory organizations ("SROs") are private corporations and do not have subpoena power, their members are required to "voluntarily" cooperate with investigators and provide testimony and documents. This has given rise to claims that FINRA, when it cooperates with governmental regulators, is acting as a quasi-governmental actor or "state actor". In turn, FINRA cites the "state actor doctrine" as the reason for non-cooperation with state securities regulators. However, courts have consistently held that the mere sharing of information with state securities regulators who are bringing administrative actions cannot trigger the application of state actor status.[2] Indeed, in one case where a party argued that the NASD[3] is a quasi-governmental agency, the court held to the contrary, stating: "NASD is not a government agency: it is a private, not-for-profit corporation chartered in Delaware."[4]

Barriers to sharing information create regulatory gaps and as we are all too aware, certain industry participants will exploit those gaps to the detriment of all investors.

While there are quite a large number of important matters addressed in both the IPA and the Discussion Draft, today I will focus on three proposals in the IPA that are of utmost importance to individual investors.

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[2] *See*, D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc., 279 F.3d 155, 16 (2d Cir. 2002). *See also*, *Marchiano v. NASD*, 134 F. Supp. 2d 90, 95 (D.D.C. 2001); *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000); *OHO DOE, v. Ficken*, Disciplinary Proceeding No. C11040006, October 15, 2007

[3] The NASD was a self-regulatory organization of the securities industry. FINRA was formed by a consolidation of the enforcement arm of the New York Stock Exchange, NYSE Regulation, Inc., and the NASD on July 26, 2007.

[4] *Graman v. Nat'l Ass'n of Secs. Dealers*, 1998 U.S. Dist. LEXIS 11624 (D.D.C. 1998). *See also*, *Desiderio v. NASD*, 191 F.3d 198 (2d Cir. 1999) (holding arbitration provision in brokers employment did not implicate state actor doctrine)

**1. Establishment of a Fiduciary Duty for Broker-Dealers Who Provide Investment Advice.**

Today, financial services providers – generally stockbrokers and investment advisers – are regulated under two different statutes, though their services are marketed in a way that makes them indistinguishable to investors. The two different regulatory schemes for broker-dealers and investment advisers provide different, uneven levels of protection for customers and clients of the financial intermediaries. Brokers are required to know a client's financial situation well enough to understand a client's financial needs, and to recommend investments that are suitable for the client based on that knowledge. This is referred to as a suitability standard. Investment advisers, on the other hand, are subject to a higher standard – the fiduciary standard. As fiduciaries, investment advisers have long established and well defined duties including: 1) an affirmative duty of care, loyalty, and honesty; 2) an affirmative duty to act in good faith; and, 3) a duty to act in the best interests of their clients.

The migration of stockbrokers into the advisory arena through the marketing of brokers as "trusted advisers" and "financial advisors" over the years has fueled confusion among investors as to the services provided by stockbrokers and investment advisers as well as the level of protection. The SEC, regrettably, has been unwilling to address this problem by, for instance, prohibiting stockbrokers from using titles that infer a relationship that is based on trust and reliance. Fortunately, the Administration's White Paper demonstrates a clear understanding of the different standards and the concomitant harm to investors and proposes the appropriate solution—a true fiduciary duty for broker-dealers that provide investment advice.

The IPA, in section 913, specifically addressed the issue of a fiduciary duty for broker-dealers and that concept is present in the Committee's Discussion Draft in Section 103. The language in Section 103 acknowledges that broker-dealers providing investment advice should be subject to a fiduciary duty. Moreover, it should be the same fiduciary duty applicable under the Investment Advisers Act of 1940 ("IA Act") to investment advisers.[5] This is such an important issue for investors, however, that Congress should make it clear through explicit language that the SEC must adopt rules no later than one (1) year from passage of the act mandating compliance by broker-dealers with this provision. There should be no equivocation in the language and to the extent that rulemaking is required it should be limited to simply effectuating this requirement.

Further, given that investment advisers are subject to a fiduciary duty, there would seem to be little benefit to inserting this language into the IA Act as suggested in Section 103 of the discussion draft. In fact, taking this step may very well open the door to an argument that the duty as described in the discussion draft is somehow different than the standard adopted by the Supreme Court.[6]

Some industry affiliated groups have also called for the imposition of a fiduciary duty standard.[7] However, upon close examination, their "new federal fiduciary standard" is hardly the pro-investor fiduciary duty that has permeated investment adviser regulation for over four decades. Rather, the industry groups are advocating for the development and imposition of an undefined concept that would potentially supplant longstanding principles of fiduciary law embodied in decades of common law. Despite assertions to the contrary, the fiduciary duty applicable today to investment advisers is a single standard that requires the adviser to put a client's interests ahead of its own at all times by providing advice and recommending investments that the adviser views as being the best for the client. Because they are subject to a fiduciary duty, investment advisers are required to provide up-front disclosures about their qualifications, what services they provide, how they are compensated, possible conflicts of interest, and whether they have any record of disciplinary actions against them.[8]

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[5] 15 U.S.C. §80b-1 *et seq*.
[6] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963)
[7] *See* Securities Industry and Financial Markets Association press release entitled "SIFMA Unveils New Pro-Consumer Reforms" available at http://www.sifma.org/news/news.aspx?id=12442. *See also*, remarks of Rick Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority available at http://www.finra.org/Newsroom/Speeches/Ketchum/P119009.
[8] This information - along with other important disclosure information about the adviser - is contained in a mandatory disclosure document and must be provided by an investment adviser to clients prior to entering into a contract for advisory services.

Brokers are generally not considered to have a fiduciary duty to customers, although this standard may apply in certain limited circumstances. Instead, brokers are required to know a client's financial situation well enough to understand the client's financial needs and to recommend investments that are suitable for the client based on that knowledge. They are not required to provide up-front disclosure of the type provided by investment advisers.

As noted in the Treasury Department's white paper on financial regulatory reform, from the point of the investor, an investment adviser and a stockbroker who provide advice appear in all respects identical. In order to address the issue of investor confusion and to better protect investors, the standard for broker-dealers providing investment advice should be, as proposed by the Treasury Department, "raised" to the fiduciary standard in order to align it with the legal framework applicable to investment advisers.

**2. Authority to Restrict Mandatory Pre-dispute Arbitration.** Today, virtually every broker-dealer includes in its customer agreements a predispute arbitration provision that forces public investors to submit all disputes that they may have with the firm and/or its associated persons to mandatory arbitration run by FINRA. The only chance of recovery for most investors who fall victim to wrongdoing on Wall Street is through a single securities arbitration forum controlled by the securities industry.

NASAA believes the "take-it-or-leave it" clause in brokerage contracts is inherently unfair to investors, and that it's time to end mandatory, industry-run arbitration. We believe that Congress should prohibit the mandatory nature of securities arbitration. Short of an outright Congressional prohibition, Section 201 of the Discussion Draft is a positive step in the right direction, but it should be amended to ***require*** that the SEC prohibit mandatory, predispute arbitration and offer a meaningful choice between binding arbitration and civil litigation. This choice should be solely that of the investor. If arbitration really is fair, inexpensive, and quick, as its adherents claim, then these benefits will prompt investors to choose arbitration. If, on the other hand, arbitration does not offer these advantages, then this mode of dispute resolution should not be forced upon the investing public.

When arbitration is inadequate to protect the substantive rights of investors, an independent judicial forum must be an option. Arbitration may be desirable and adequate if both parties knowingly and voluntarily agree to waive the constitutional rights provided in court. If an investor decides to waive his or her constitutional rights, this decision should be made at the time the dispute arises, not at the time the account is opened. At this point, both parties may make the determination whether their particular dispute is best decided in a court of law (especially small claims court) with court-supervised discovery, a written opinion, and appellate review of complex legal issues.

Securities arbitration cases are heard by a three-member panel that includes one "non-public" or securities industry member, and two "public" members, who may have worked in the industry. Neither of the public arbitrators is required to be an investor advocate, even though the non-public arbitrator *is* required to be an industry representative, and only FINRA, the industry SRO, selects who is qualified to be in the arbitrator pool. The arbitration process will be both perceptively and fundamentally unfair to investors as long as arbitration panels include a mandatory industry representative of the securities industry and include public arbitrators who could have ties to the industry.

In a 2008 study for the Securities Industry Conference on Arbitration (SICA)[9], entitled, "Perceptions of Fairness of Securities Arbitration: An Empirical Study" ("the SICA study"),[10] Professors Jill Gross and Barbara Black surveyed participants in the

[9] The Securities Industry Conference on Arbitration (SICA) was established in 1977 with the support of the SEC to create a Uniform Arbitration Code to harmonize the rules of the various SRO arbitration forums then in existence. Since 1977, SICA has met on a regular basis to discuss SRO arbitration and to review and revise the Uniform Code. Besides three public members, all the SROs also have had voting membership in SICA along with the SIA (Securities Industry Association, now SIFMA), and the SEC has regularly attended quarterly meetings. SICA also drafted and revised the Arbitrator's Manual that was in use at the NASD and NYSE.

[10] Gross, Jill and Black, Barbara, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (February 6, 2008). U of Cincinnati Public Law Research Paper No. 08-01. Available at SSRN: http://ssrn.com/abstract=1090969

arbitration process. According to the SICA study, nearly half (48 percent) of the customers surveyed believed their arbitration panel was biased; 76 percent of the customers found arbitration "very unfair" or "somewhat unfair" as compared to court; 70 percent were dissatisfied with the outcome; more than 60 percent would not choose arbitration in the future; and 49 percent stated that the arbitration process was too expensive.

The SICA study's results are alarming, and they support what state regulators have been hearing from investors in their states – investors believe that the arbitration forum they are forced to participate in is rigged against them.

No further studies are necessary. NASAA believes that the securities arbitration system should be truly voluntary, and the balance in the composition of FINRA arbitration panels should be restored.

**3. Aiding and Abetting.** One of the purposes of the Securities Act of 1933 and the Investment Advisers Act of 1940 was to establish higher standards of conduct in the securities industry than already existed in common law. Sections 206 and 207 of the Discussion Draft do much to further this purpose by explicitly providing the SEC the authority to prosecute those secondary actors who aid and abet violations of these Acts. However, NASAA believes that the interests of investors would be best served by amending Sections 206(b) and (c) and 207(f) to remove the language, "brought by the Commission." By expressly stating "brought by the Commission", the language may inadvertently be read as an implicit exclusion of private rights of action. Certainly this is what defendants will argue.

In passing the original legislation, Congress implicitly authorized a private right of action and for decades thereafter, courts allowed private suits. The right to bring a private suit for aiding and abetting was restricted by the Supreme Court in *Central Bank* *of Denver*[11] and basically eliminated by the Supreme Court in *Stoneridge Investment Partners*.[12] The decisions in these cases interpret the securities laws in a way that protects big business, emboldens secondary actors to engage in manipulative practices, and sets an extremely high bar for defrauded shareholders to seek compensation from wrongdoers. Corporations and secondary actors often seek short-term profits, big bonuses, and large fees, and in too many instances these goals can be achieved by cooking the books or engaging in sham transactions. Given the complexity of corporate activity, secondary actors such as accountants and lawyers now play a critical in the preparation and dissemination of public information. If they are allowed to avoid liability for their actions, there will be no deterrent to prevent them from engaging in fraudulent schemes.

In denying investors the right to bring private aiding and abetting actions, the majority in *Stoneridge* contends that such actions can be brought by the SEC on behalf of shareholders. In reality, the SEC is not in the position to take on this task. In an April 2009 speech, Chairman Schapiro stated: "Quite frankly, our enforcement and examination resources have been seriously constrained in recent years." (Speech to Council of Institutional Investors, April 6, 2009). In its March 2009 performance audit, the Government Accounting Office ("GAO") found that "Investigative Staffing Has Fallen and Resource Challenges Undermine the Ability to Bring Enforcement Actions."[13] Further, the GAO Report stated, "Enforcement management and investigative attorneys told us that resource challenges hinder the ability to bring cases," and "Investigative attorneys with whom we spoke cited a number of resource challenges that have undercut their efforts, causing significant delays in bringing cases, reducing the number of cases that can be brought, and potentially undermining the quality of cases."[14]

Critics of private securities actions claim that such cases provide little benefit to victims, punish innocent shareholders, and unjustly reward plaintiffs' lawyers. These

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[11] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).
[12] *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008).
[13] GAO, *Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement*, GAO-09-358 (Washington, D.C.: March 31, 2009)
[14] *Id.*

arguments have limited merit. With regard to victim compensation, over the years, private actions resulted in greater recoveries for shareholders than the compensation from regulatory actions. The fact that victims were not able to recover full damages is the result of a number of factors including the corporation's inability to pay and shareholders' desire to settle for less rather than to spend more time in litigation. The contention that paying defrauded victims harms innocent, current shareholders is not applicable in cases involving wrongdoing by secondary actors. Shareholders want accountability and the right to sue for wrongdoing; management and secondary actors are the ones invoking shareholder harm arguments in their attempt to avoid all accountability for their illegal acts. If management is concerned about current shareholders, it might alleviate the cost to shareholders by stripping away the bonuses, high salaries, and stock options awarded to those who participated in the fraud and make those assets available for victim restitution. With regard to plaintiffs' lawyers' fees, it is important to understand that class action settlements, including attorney's fees, are reviewed by the courts. Judges decide whether plaintiffs' attorneys' fees are appropriate.

Allowing investors to file aiding and abetting cases will not open the floodgates of litigation and stifle businesses. Private suits were allowed prior to the *Central Bank* and *Stoneridge* decisions and businesses grew and flourished during those years. It is important to remember that corporate actors who engage in fraud are not merely making bad business decisions - no legitimate business school teaches deceptive acts and practices as part of its curriculum. Deceptive and manipulative transactions that are intended to defraud investors cannot be classified as ordinary business decisions and perpetrators, whether primary or secondary actors, should not be allowed to hide behind corporate law protections.

The dissent in the *Stoneridge* case noted that Congress enacted Section 10(b) of the Securities Exchange Act with the understanding that federal courts respected the principle that every wrong would have a remedy. If aiding and abetting liability is not restored by Congress, innocent victims of investment fraud will be left without a remedy against the entities or persons that assisted in perpetrating the fraud.

*Additional Reforms to Better Protect Investors*

**Increased State Regulation of Investment Advisers.** As evidenced by the Inspector General's report on the Madoff affair[15] and the testimony of SEC Chairman Schapiro and other SEC staff before Congress,[16] the bulk of federally covered investment advisers are examined infrequently. To the extent examinations are conducted, the SEC has demonstrated a lack of fundamental understanding as to the business of registrants, even with experienced staff.[17] A clear "oversight gap" has existed for some time and is now emerging into public view. NASAA members are fully prepared and equipped to fill this gap by accepting responsibility for the oversight of investment advisers up to $100 million in assets under management.

NASAA members possess a number of unique qualifications that ensure the permanent closure of the "oversight gap." NASAA members are geographically proximate to the investment adviser population, and this proximity ensures accessibility. Investors may walk into the offices of state securities regulators and be assured that their complaint will be evaluated. Because of this accessibility, state regulators are most often the investor's first point of contact when there is a problem with their adviser. NASAA members have frequent contact with registrants, which in turn, allows for the detection of wrongful conduct in its nascent stage. Further, wrongful conduct is generally prevented in the first instance due to the frequent contact with state examiners. Plus, NASAA members are the only regulators that license investment adviser representatives – the

[15] *See*, Report of the Office of Inspector General, U.S. Securities and Exchange Commission, Review and Analysis of OCIE Examinations of Madoff Investment Securities, LLC, September 29, 2009 at Page 8.

[16] *See*, Testimony of SEC Chairman Mary L. Schapiro before the Subcommittee on Financial Services and General Government, June 2, 2009, Testimony of Andrew J. Donohue, Director, SEC Division of Investment Management before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, July 15, 2009. *See also,* Appendix to Testimony of Chairman Mary L. Schapiro before the United States Senate Committee on Banking, Housing and Urban Affairs, March 26, 2009 (noting 86 percent of SEC registered investment advisers were unexamined in 2008).

[17] Testimony of H. David Kotz, Inspector General, U.S. Securities and Exchange Commission before the U.S. Senate Committee on Banking, Housing and Urban Affairs, September 10, 2009. *See also*, Report of the Office of Inspector General, U.S. Securities and Exchange Commission, Review and Analysis of OCIE Examinations of Madoff Investment Securities, LLC, September 29, 2009.

individuals providing investment advisory services. Our members thereby have a view of not only the entities providing investor advisory services, but also the individuals who interact with investors.

Additionally, NASAA members have nearly 50 years of experience conducting examinations and taking enforcement actions against investment advisers. The experience of NASAA members in the application of fiduciary duty sets them apart from SROs whose experience is limited to the suitability standard. Because investment adviser regulation is complex and substantively different from the regulation of broker-dealers, the experience of NASAA members is all the more critical. It is vital that the "oversight gap" be closed as quickly as possible, yet training to the level of basic competence would take years. NASAA members are trained in investment adviser regulation, and are already experts in such oversight. NASAA members are ready to deploy their resources now.

State securities regulators have a long record of investor protection and adviser oversight that is superior to the federal regime and any contemplated SRO model because of the advantages of proximity, experience, and knowledge.

**Establishment of a Systemic Risk Council.** Because individual behavior is not reliably rational during just those times when systemic safety is in jeopardy, NASAA believes that optimal communication and associated systemic risk mitigation could best be accomplished by establishing an independent "Systemic Risk Council," in which both state and federal financial services regulators would conduct high-level strategy meetings where analyses would be shared and prophylactic risk assessments and recommendations would be made.

Any solution ultimately decided by Congress must provide enhanced communication among state and federal regulatory authorities. A "Systemic Risk Council" would effectively establish a crisis management protocol with clear and regular lines of communication among all regulators.

State and federal governments are the natural providers of systemic safety including the need to insure liquidity, stability and reliability, and a well-functioning financial system. The private sector cannot provide such systemic safety.

Including state regulators on the council is necessary and appropriate. In all financial sectors, state regulators gather and act upon large amounts of information from industry participants and from investors. Consequently, they serve as an early warning system. As a general proposition, state regulators are usually the first to identify risks and related trends that are substantial contributing factors to systemic risk. The complexity of financial markets has exceeded the competency capacity of federal regulators alone. This provides further evidence for the need of a state banking, insurance, and securities regulator on the “Systemic Risk Council.”

***Conclusion***

NASAA appreciates the opportunity to present our views on financial services regulatory reform. State securities regulators believe that enhancing our securities laws and regulations and ensuring they are being vigorously enforced is the key to restoring investor confidence in our markets. NASAA and its members are committed to working with the Committee to ensure that the nation’s financial services regulatory regime undergoes the important changes that are necessary to enhance Main Street investor protection, which the states have effectively provided for nearly 100 years.