States: On the Frontlines of Investor Protection

PROBLEM: $2 billion/yr. Losses in Penny Stocks	
State Initiative	**1989:** States determined penny stock offerings by newly formed shell companies to be per se fraudulent. These “blank check” companies had no business plan except a future merger with an unidentified company.
National Response	**1990:** Congress passed Penny Stock Reform Act, which mandated SEC to adopt special rules governing sale of Penny Stocks (<$5.00 per share) and public offerings of shares in blank check companies (SEC Rule 419).
PROBLEM: $6 billion/yr. Losses in Micro-cap Stocks	
State Initiative	**1996-97:** 33 States participated in sweep of 15 broker-dealer firms that specialized in aggressively retailing low priced securities to individual investors. States found massive fraud in firms’ manipulation of shares of start-up companies, most of which had no operating history.
National Response	**1997-98:** Congress held hearings on fraud in the micro-cap securities markets (shares selling between $5-10). **2002:** Congress passed Sarbanes-Oxley Act, which made certain state actions a basis for federal statutory disqualification from the securities industry.
PROBLEM: Risks of Securities offerings on the Internet	
State Initiative	**1996-97:** States issued uniform interpretative guidance on use of Internet for legitimate securities offerings and dissemination of product information by licensed financial services professionals.
National Response	**1998:** SEC issued interpretative guidance based on the States’ Model on the use of Internet for securities offerings and dissemination of services and product information by licensed financial services professionals.
PROBLEM: Risks of Online Trading	
State Initiative	**1999:** In a report on trading of securities on the Internet, States found that investors did not appreciate certain risks, including buying on margin and submitting market orders.
National Response	**2001:** SEC approved a new NASD rule requiring brokers to provide individual investors with a written disclosure statement on the risks of buying securities on margin.
PROBLEM: Risks of Day Trading	
State Initiative	**1999:** In a report on individuals engaged in day trading, States found that day trading firms failed to tell prospective investors that 70% of day traders would lose their investment while the firm earned large trading commissions.
National Response	**2000:** SEC approved new NASD rules making day trading firms give written risk disclosure to individual investors. **2001:** SEC approved new NASD and NYSE rules governing margin extended to day traders.
PROBLEM: Research Analyst Conflict of Interest	
State Initiative	**2002-03:** States investigated and helped focus attention on conflicts of interest between investment analysts and major Wall Street firms.
National Response	**2002-03:** The SEC, NASD, NYSE, and states reached a landmark $1.4 billion global settlement and firms agree to reform practices.
PROBLEM: Illegal Mutual Fund Trading Practices	
State Initiative	**2003:** States uncovered illegal trading schemes that had become widespread in the mutual fund industry.
National Response	**2003-2004:** SEC, NASD and NYSE launch investigations; reform legislation introduced in Congress but fails to gain support; SEC initiates wide-ranging effort to reform certain fund regulations.
PROBLEM: Senior Investment Fraud	
State Initiative	**2008:** After calling attention to widespread fraud against senior investors, NASAA members approved a model rule prohibiting the misleading use of senior and retiree designations and numerous states have adopted the model through legislation or regulation.
National Response	**2008:** Sen. Herb Kohl, chair of the U.S. Senate Special Committee on Aging, introduced legislation that would provide grants to states to enhance the protection of seniors from being misled by false designations.
PROBLEM: Auction Rate Securities	
State Initiative	**2008:** Based on investor complaints, states launched a series of investigations into the frozen market for auction rate securities. The investigations led to settlements with 11 major Wall Street firms to return $50 billion to ARS investors.
National Response	**2006:** SEC looked into underwriting and sales practices of auction rate securities. While it did discover and try to remedy certain manipulative practices, the SEC failed to identify or correct fundamental conflicts of interest and self dealing that pervaded the auction rate market.

SOURCE: North American Securities Administrators Association
Updated: January 2009