

# NASAA Insight

*The Voice of State & Provincial Securities Regulation*

Fall 2011



## NASAA Voices Opposition to Investment Adviser SRO

The North American Securities Administrators Association (NASAA) outlined its vigorous opposition to draft legislation that would require state and federally registered investment advisers that conduct business with retail customers to be members of a self-regulatory organization in testimony before the House Subcommittee on Capital Markets.

"NASAA vigorously opposes the creation of a self-regulatory organization for state regulated investment advisers," Pennsylvania Securities Commissioner Steve Irwin told the panel. "Moreover, NASAA reiterates its significant and long-standing concerns regarding any effort to establish a self-regulatory organization for investment advisers."



*Pennsylvania Securities Commissioner Steven Irwin testifies on NASAA's opposition to the designation of an investment adviser SRO at a hearing on Sept. 13.*

Irwin, chair of NASAA's Federal Legislation Committee, told the panel in September that investment adviser regulation should continue to be the responsibility of state and federal governments and that these regulators must be adequately funded to carry out their responsibilities.

The draft legislation was released by House Financial Services Committee Chairman Spencer Bachus. "It appears that the Chairman's draft would nationalize the regulation of small and mid-sized investment advisers. This would be a significant mistake

that does not benefit Main Street investors, nor promote small business interests," Irwin said.

**See p. 4 >>**

## Nebraska Regulator Jack Herstein to Lead NASAA

Jack E. Herstein, Assistant Director of the Nebraska Department of Banking and Finance Bureau of Securities, in September began a one-year term as NASAA president.



*NASAA President Jack Herstein*

Herstein's presidential address commemorated the centennial anniversary of the first state securities law and the launch of the next century of investor protection.

"For the past 100 years, securities regulators in the states, provinces and territories of North America have delivered effective protection for investors and efficient regulation

for industry. We have served a distinguished role in safeguarding the assets and maintaining the confidence

of investors throughout North America," Herstein said.

Herstein said his presidency will focus on ensuring that state regulatory authority is preserved. "As we have seen since NSMIA, our authority has been under attack," he said. "I ask fellow regulators to join us in resisting efforts to reduce investor protections by restricting or eliminating state regulatory authority."

Herstein praised his fellow NASAA members for their commitment to investor protection through education and strong enforcement of state securities laws. "We are in the trenches every day, stepping up when and where others may be unlikely to act," he said.

"Dodd-Frank recognized NASAA's leadership and record of accountability and gave state securities regulators new authority to address the challenges facing 21st century investors," he said.

For the past year, Herstein has served as NASAA's president-elect. Previously, he served as a member of the Board of Directors, treasurer and Corporation Finance Section chair.

### President's Message: Jack Herstein



I want to thank all who joined us in Kansas in September to celebrate the centennial anniversary of state securities regulation and launch the next century of investor protection.

For the past 100 years, securities regulators in the states, provinces and territories of North America have delivered effective protection for investors and efficient regulation for industry. I am proud to have been a part of this history for the past 34 years, after joining the Nebraska Bureau of Securities in 1977 as a securities examiner.

While I was being handed the gavel in Wichita to assume the NASAA presidency, 1,200 miles to the east, my colleague from Pennsylvania, Steve Irwin, testified before a congressional panel and outlined our vigorous opposition to the creation of a new self-regulatory organization for investment advisers.

While NASAA has traditionally favored government regulation over industry self-regulation, we need to acknowledge that self-regulation is not going away. I intend to continue Dave Massey's work to enhance our relationship with FINRA. As is frequently the case, that which unites us is greater than that which divides us.

I look forward to working with my fellow securities regulators in state, provincial and federal government. We work well together in our shared responsibility to protect investors.

Securities and insurance regulators also have much in common. It is not uncommon for one state agency to regulate both industries. In Nebraska, we are proud of the strong working relationship between our Department and the Department of Insurance. We coordinate investigations and examinations where there is a shared interest, and meet to discuss common areas of concern. I encourage each securities regulator to have similar meetings with your jurisdiction's insurance regulator, and I intend to approach the National Association of Insurance Commissioners to discuss our common goals.

I will also reach out to industry associations, such as SIFMA. Collaboration between regulators and industry groups is especially important to leverage our resources for the protection of investors. I look forward to hearing from industry representatives in the coming year to enhance our already strong and positive working relationship.

My primary goal over the next year will be to focus on ensuring that state regulatory authority is preserved. A number of legislative proposals currently before Congress contain language that would preempt state regulatory authority. We will take each challenge as it comes and strongly defend against any attempt to reduce investor protections by restricting or eliminating our authority.

---

### Executive Director's Message: Russ Iuculano



The NASAA Corporate Office congratulates President Herstein on his timely inaugural remarks. We look forward to working with him on achieving his goal of preserving state regulatory authority.

That goal is already being challenged, notably at a recent hearing of the House Subcommittee on Capital

Markets that centered on several measures that would diminish state regulatory authority. NASAA testified at the hearing to speak out strongly in opposition to these measures.

On September 21, Arkansas Securities Commissioner Heath Abshire, chair of NASAA's Corporation Finance Section, presented NASAA's concerns with the unintended consequences investors could face from legislative efforts to loosen

regulations on how new and small businesses raise money (see p. 5). He expressed NASAA's strong opposition to two new proposals that purport to spur job growth by rolling back investor protections or preempting state securities law. H.R. 2930, a bill that would deregulate "crowdfunding" offerings by creating a new exemption from federal registration for these offerings and by preempting state oversight, and H.R. 2940, which would lift the ban on general solicitations in connection with offerings made under Regulation D Rule 506, both advanced to the full House Financial Services Committee.

This is an important opportunity to join us in voicing opposition to any measure that preempts the states' authority to protect investors. I encourage the NASAA membership to contact your state's representatives to express your concerns about the flaws in these bills from an investor protection standpoint.

We will keep you apprised of further developments.

## Top Investor Traps

*NASAA Warns Investors of Con Artists Seeking Profit in Get-Rich Schemes Tied to Economic Uncertainty*

NASAA released its annual list of financial products and practices that threaten to trap unwary investors, many by taking advantage of investors troubled by lingering economic uncertainty and volatile stock markets.

"Con artists follow the news and seek ways to exploit the headlines to their advantage while leaving investors holding an empty bag," said David Massey, NASAA Past-President and North Carolina Deputy Securities Administrator.

"Promoters often offer investors an opportunity to get in on the 'ground floor' of new technology or ideas to help others and make a great economic return," Massey said. "Unsuspecting investors can be lured into these schemes, especially if they sound familiar. These offerings require careful research."

The following alphabetical listing of the Top 10 financial products and practices that threaten to trap unwary investors was compiled by the securities regulators in NASAA's Enforcement Section. Detailed information is available at [www.nasaa.org](http://www.nasaa.org).

- **PRODUCTS:** distressed real estate schemes, energy investments, gold and precious metal investments, promissory notes, and securitized life settlement contracts.
- **PRACTICES:** affinity fraud, bogus or exaggerated credentials, mirror trading, private placements, and securities and investment advice offered by unlicensed agents.

## NASAA Launches New Website

*Redesigned site offers easier access to information*



In October, NASAA launched its newly redesigned website, featuring improved navigation, a multimedia spotlight area, enhanced search functionality and a clean, modern look. The new website remains located at [www.nasaa.org](http://www.nasaa.org).

## Self-Directed IRAs and the Risk of Fraud

NASAA and the SEC's Office of Investor Education and Advocacy have issued an investor alert to warn investors of the potential risks associated with investing through self-directed Individual Retirement Accounts (IRAs).

NASAA has noted a recent increase in reports or complaints of fraudulent investment schemes that utilized a self-directed IRA as a key feature. State securities regulators have investigated numerous cases where a self-directed IRA was used in an attempt to lend credibility to a fraudulent scheme. Similarly, the SEC has brought numerous cases in which promoters of fraudulent schemes steered investors to self-directed IRAs.

While self-directed IRAs can be a safe way to invest retirement funds, investors should be mindful of potential fraudulent schemes when considering a self-directed IRA. Investors should understand that the custodians and trustees of self-directed IRAs may have limited duties to investors, and that the custodians and trustees for these accounts will generally not evaluate the quality or legitimacy of an investment and its promoters.

The alert is available on the NASAA website at [www.nasaa.org](http://www.nasaa.org).

## Social Networking Fraud

*Con Artists Tap into Social Networking Sites in Search of New Victims*

As people increasingly turn to online social networking sites to interact with one another, so have con artists who lurk in the virtual shadows with shady investment deals to pitch to unsuspecting investors.

"Just because someone has 'friended' you online does not mean that person is your friend when it comes to investing," said NASAA Past-President and North Carolina Deputy Securities Administrator David Massey. "The person behind the profile may be deliberately mimicking your likes and interests to lure you into a scam."

"A con artist can take advantage of how easily people share background and personal information online by using this information to make a highly targeted pitch to 'friends' within that social group," Massey said.

NASAA's social networking advisory advises investors to watch for red flags common to online investment schemes and offers tips on how to protect against fraud in social networking. The advisory is available on NASAA's website at [www.nasaa.org](http://www.nasaa.org).

# IA SRO Concept Raises Many Concerns

*States see little benefit in constructing a new layer of bureaucracy*

*Continued from p. 1*

Irwin's testimony outlined NASAA's concerns with outsourcing regulation to a non-government entity. "When it comes to regulation of investment advisers, government regulators bring to the table decades of experience unmatched by any entity in existence," Irwin said. "We see little benefit in constructing a new layer of bureaucracy, with its incumbent expense."

State securities regulators are concerned by the conflicts of interest and lack of accountability, transparency and independence of SRO regulation.

"There are numerous issues that must be addressed before an SRO for SEC-registered investment advisers should even be considered," Irwin said.

For example, he noted that no matter how many safeguards are put in place, SROs have substantial

and inherent conflicts of interest that governmental regulators do not.

"This is particularly true where industry and investor interests conflict, as in the case of mandatory pre-dispute arbitration and the disclosure or expungement of prior settlements, judgments and investor claims," he said. "As a membership organization, FINRA answers firstly to its members and not to the investing public. Regardless of safeguards that may be put in place, the conflicts will still exist."

In another area of concern, Irwin noted that SROs lack transparency in that they are not subject to the Freedom of Information Act and other similar public record requirements, as are state and federal regulators. "The end result is that important public information is withheld by the SRO from the investing public," Irwin said.

## Key Points of NASAA Testimony

### State Regulatory Authority Must be Preserved

Any increased SRO role with respect to federally covered IAs cannot displace state laws. The idea that state law might be preempted by administrative rules issued by a private corporation is unconscionable. Preemption occurring because of industry self-made rules would undermine the basic tenets of federalism and the democratic values from which regulation derives legitimacy.

### Bachus Plan Targets Small, Mid-sized IAs for SRO

The Bachus discussion draft would require small and mid-sized IA firms to register with a new IA SRO. These advisers usually operate in a single state. Shifting their regulation to a central office would subject these small businesses to redundant regulation and add unnecessary costs to support the new organization. States are in the best position to be the primary regulator for small and mid-sized firms.

### Conflicts of Interest

The existing securities industry SRO model – as typified by FINRA – is replete with conflicts of interest. Any SRO that depends on its members as its primary funding source faces a heightened susceptibility to industry capture.

### Barriers to Collaboration

The SRO model brings with it a barrier to collaboration and cooperation in the form of the "State-Actor Doctrine." This legal concept considers whether the conduct or activities of a private party can be considered a "government action," which, in turn, would force private entities to comply with the Constitution's due process provision. FINRA uses the "state-actor doctrine" as a basis for non-cooperation with state securities regulators, and consistently cites its desire to avoid being labeled a "state actor" as an excuse to refuse state regulators' requests for investigatory cooperation. FINRA cannot legitimately claim that the mere sharing of information makes it a state actor. By doing so, FINRA is creating an unnecessary regulatory inefficiency that results in a heavy burden on investor protection.

### Transparency

The regulatory work performed by SROs lacks transparency. SROs are not subject to the Freedom of Information Act or other records requirements.

### Accountability

SROs cannot match the accountability of government regulators, nor the proximity to and familiarity of state regulators with the investment advisers when considering investor protection and regulatory thoroughness.

## NASAA Testimony: Capital Formation Proposals Must Not Weaken Investor Protection

In testimony before the House Subcommittee on Capital Markets and Government Sponsored Enterprises, NASAA on September 21 outlined the unintended consequences investors could face from legislative efforts to loosen regulations on how new and small businesses raise money.

"State securities regulators are acutely aware of the difficult economic environment and its effects on job growth. No state securities regulator seeks to inhibit economic recovery through regulation that is overly burdensome or restrictive," said Heath Abshure, Arkansas Securities Commissioner, chair of NASAA's Corporation Finance Section, and an observer member of the Securities and Exchange Commission's Advisory Committee on Small and Emerging Companies.

Abshure's testimony came during a hearing focused on three legislative proposals to promote small business capital formation and job creation: the Small Company Capital Formation Act of 2011 (H.R. 1070), the Entrepreneur Access to Capital Act (H.R. 2930) and the Access to Capital for Job Creators Act (H.R. 2940).

"While Congress' desire to facilitate access to capital for new and small businesses is warranted, it must be sure to do so in a careful and deliberate fashion. Investors must be assured that they are protected to the fullest extent possible," Abshure testified. "The methods of facilitating small capital formation must reasonably balance the needs of businesses with the needs of investors."

As an example of unintended legislative consequences, Abshure recounted the harmful impact investors have faced since 1996 when Congress preempted states from reviewing certain private placement offerings before they were sold to the public.

Although properly used by many legitimate issuers, a registration exemption in SEC Regulation D Rule 506 has become an attractive option for individuals who would



*Heath Abshure, Arkansas*

otherwise be prohibited from engaging in the securities business.

NASAA urged Congress to balance the need for investor protection with the need to help small businesses raise money.

"By ignoring smart regulation and the crucial role of state securities regulators, Congress could enact policies intended to strengthen the economy that have precisely the opposite effect," Abshure said. "The challenge for Congress today is to find policies that achieve the right balance between the competing objectives of promoting investment in real and valid business opportunities and protecting citizens from inappropriate risk and fraudulent schemes."

### In Focus:

#### **The Entrepreneur Access to Capital Act of 2011 (H.R. 2930)**

This bill would amend the securities laws to provide for registration exemptions for certain crowdfunding securities. Specifically, it would exempt offerings of less than \$5 million, where the maximum individual investor contribution is the lesser of 10 percent of an investor's annual income or \$10,000 per investor. Section 4 of H.R. 2930 expressly preempts state law for the proposed new crowdfunding exemption by classifying these offerings as "covered securities." It is crucial that the states retain full authority to review securities offerings, particularly in this area, as there has been and continues to be significant fraud in this segment of the market.

#### **The Access to Capital for Job Creators Act of 2011 (H.R. 2940)**

This bill would expand the exemption under Regulation D Rule 506 by requiring the SEC to remove the long-standing prohibition against the general solicitation of these offerings. Such an action would exacerbate the regulatory black hole created in 1996, when Congress passed MSMA and stripped the states of their authority to fully regulate in this area. Since the enactment of NSMIA, Regulation D Rule 506 offerings, which are designed to be private offerings, have received virtually no regulatory scrutiny.

## NASAA Commemorates 100 Years of Investor Protection



*Colorado Securities Commissioner and conference co-chair Fred Joseph welcomes regulators and industry to NASAA's celebration of 100 years of investor protection.*



*North Carolina Deputy Securities Administrator and NASAA Past President David Massey urges NASAA members to remain vigilant in their protection of "mom and pop" investors.*



*Kansas Securities Commissioner and conference co-chair Aaron Jack looks on as an actor portraying the father of blue sky law J.N. Dolley welcomes NASAA to Wichita.*

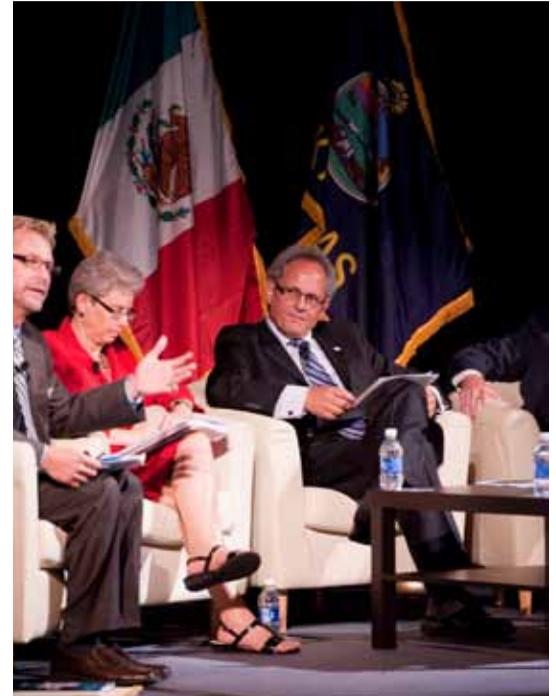


*A panel of distinguished NASAA veterans and alumni reflect on the evolution of state securities regulation. Moderated by Iowa Securities Bureau Securities Counsel Craig Goettsch (center), the panel includes (from left): Lewis Brothers, former Virginia Securities Director and NASAA President; Denise Voigt Crawford, former Texas Securities Commissioner and NASAA President; Philip Feigin, former Colorado Securities Commissioner and NASAA President; and Robert Lam, Pennsylvania Securities Commissioner.*

## And Ushers in the Next Century of Investor Protection



California Corporations Commissioner and NASAA President-elect Preston DuFauchard (center) moderates a debate of key Dodd-Frank issues between investor and industry advocates, including FINRA Vice Chairman Stephen Luparello (left) and the Consumer Federation of America's Director of Investor Protection Barbara Roper. Other panelists included SIFMA Executive Vice President Ken Bentsen and Investment Advisers Association Vice President for Government Relations Neil Simon.



The future of investor protection and securities regulation was the focus of a panel moderated by Texas Securities Commissioner Benette Zivley (left). Panelists included: Elizabeth Jacobs, Deputy Director, Office of International Affairs, U.S. Securities and Exchange Commission (center); Jean Lorrain, Director of International Affairs for Quebec's securities regulator, the Autorité des marchés financiers (right); and George Arnett, Executive Vice President and General Counsel, HedgeMark International, LLC.



Changing of the Guard: David Massey (left) completes his term as NASAA President by handing the gavel to Jack Herstein of Nebraska.

**"Together, we can work toward a future where a culture of responsibility is shared among regulators, industry, and investors; where regulators never neglect their duty to protect investors; where financial innovation flourishes to benefit everyone and where the interests of investors always come first." ~ Jack Herstein**



## NASAA: Because Every Investor Deserves Protection

### About Us

The North American Securities Administrators Association (NASAA) is a voluntary association of securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada and Mexico.

Organized in 1919, NASAA is the oldest international organization devoted to investor protection.

As the preeminent organization of securities regulators, NASAA is committed to protecting investors from fraud and abuse, educating investors, supporting capital formation and helping ensure the integrity and efficiency of financial markets.



North American Securities  
Administrators Association  
750 First Street NE  
Suite 1140  
Washington, D.C. 20002

### Contact NASAA

Phone: 202-737-0900  
Fax: 202-783-3571

### Visit NASAA's New Website

[www.nasaa.org](http://www.nasaa.org) 

### NASAA Public Policy Conference

Washington Court Hotel  
Washington, DC  
May 7, 2012

*The NASAA Insight is a quarterly publication of the North American Securities Administrators Association.*

### Investment Advisers

#### *IARD System Fee Waiver Continuation Approved*

NASAA will waive the initial set-up and annual system fees paid by investment adviser firms (IAs) and investment representatives (IARs) to maintain the Investment Adviser Registration Depository (IARD) system.

"State securities regulators are sensitive to the cost of compliance borne by investment advisers, many of which operate small businesses in local communities," said NASAA President Jack Herstein.

"Any cost savings that can be achieved without weakening investor protection will benefit both investors and small businesses in a struggling economy," Herstein said.

NASAA's Board approved the system fee waiver and will continue to monitor the system's revenues and make future adjustments, including waiving the system fees, if warranted, Herstein said.

#### *Coordinated State Exams Identify IA Deficiencies*

As state securities regulators prepare to assume increased regulatory oversight of investment advisers managing under \$100 million in assets, NASAA released an updated series of recommended best practices that investment advisers should consider to minimize the risk of regulatory violations.

"Our goal in identifying deficiencies and recommending best practices is to help investment advisers strengthen their internal compliance programs and improve the services they provide to clients," said NASAA President Jack Herstein.

Examinations of 825 investment advisers uncovered 3,543 deficiencies in 13 compliance areas. Categories with the greatest number of deficiencies involved registration, books and records, unethical business practices, supervision, and advertising.