NASAA Insight

The Voice of State & Provincial Securities Regulation

NASAA

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NASAA to Congress: No SRO for State IAs

Legislation to create a self-regulatory organization (SRO) for investment advisers would impose redundant regulation and costs on thousands of small businesses in communities throughout the United States that could force many of these local firms to close their doors, NASAA told the House Financial Services Committee.

During a June 6 hearing, Texas Securities Commissioner John Morgan said state securities regulators are "extremely concerned" about the impact the legislation would have on state-registered investment advisers and the clients they serve. "In short, the most urgent problem with this legislation is that it has the very real potential to be a job killer."

NASAA's testimony came during a hearing on H.R. 4624, the "Investment Adviser Oversight Act of 2012."

Morgan said state securities regulators share the Committee's concern regarding the oversight and examination of federally registered investment advisers. "NASAA recognizes these problems place investors at risk, and agrees that Congress should act to address them," he said. "Crucially, however, no similar gap exists with respect to investment adviser regulation in Texas, nor in the overwhelming majority of states."

Texas Scurities Commissioner John Morgan delivers NASAA's testimony at a June 6 hearing on H.R. 4624.

H.R. 4624 embraces a "one size fits all" approach to regulation, Morgan said. The bill will require some federally registered investment advisers and most state-registered investment advisers to become members of an SRO, pay membership fees to the SRO, comply with its rules, and be subject to inspection by the SRO.

"As a matter of policy, investment adviser regulation is a governmental function that should not be delegated to an SRO," Morgan said.

"Above and beyond NASAA's concerns with the SRO model and its application to investment adviser regulation, state securities regulators are adamantly opposed to H.R. 4624 because we believe it would subordinate state regulators to an SRO, impose redundant regulation and new costs on small and mid-size investment advisers that are impossible to justify, and very likely put many of the small firms that we regulate out of business," Morgan said.

The Investment Adviser Switch is On

The long-awaited switch from federal to state oversight of small and mid-sized investment advisers becomes effective on June 28.

As mandated by the Dodd-Frank Act nearly two years ago, investment advisers with $100 million or less in assets under management are switching from federal to state oversight.

"The switch is currently the largest single regulatory event involving a coordinated effort by the states and the SEC," said Jack E. Herstein, NASAA president and assistant director of Nebraska's Department of Banking & Finance, Bureau of Securities.

The latest data from the SEC puts the number of switching advisers at about 2,400 firms.

The SEC estimates that it will have oversight responsibility for about 10,500 investment advisers while about 17,000 investment advisers will be registered with state securities regulators.

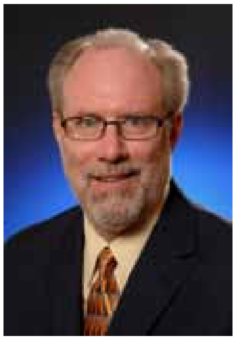
"The SEC has kept the states updated about switching advisers, including important information about recent examinations of switching advisers. This information will be used by state regulators to guide their exam schedules for the upcoming year," Herstein said.

States have been preparing for the switch for more than two years. A number of states have increased their examination staffs in anticipation of the switch. NASAA members also have developed ways to maximize resources.

SEC Commissioner Luis Aguilar recently praised the collaborative efforts of the SEC and NASAA members "to make this process as seamless for registrants as possible."

"The bottom line is that we are ready to accept our increased regulatory oversight," Herstein said.

President's Message: **Jack E. Herstein**



When we met last fall in Wichita, all eyes were focused on draft legislation released by House Financial Services Committee Chairman Spencer Bachus (R-AL) to create a self-regulatory organization for investment advisers.

This idea was soon pushed to the backburner by the runaway freight train that steamrolled its way through Congress to become the Jumpstart Our Business Startups (JOBS) Act.

It is no secret that state securities regulators believe the JOBS Act is an investor protection disaster waiting to happen. The JOBS Act is not about jobs. It is a fundamentally flawed product of a rush to legislate. Election-year politics blinded Congress and the White House to the unintended consequences of their actions, which however well intentioned could open the floodgates to investment fraud. Unfortunately, many investors may be harmed before this mistake is corrected.

With that investor protection debacle now out of the way, Congress is turning its attention back to the idea of outsourcing governmental responsibility and expanding the financial service industry's self-regulatory regime to include investment advisers.

We agree with Chairman Bachus that the oversight of federally regulated investment advisers needs to be strengthened, but we believe his approach overreaches by requiring state-regulated investment advisers to become members of the proposed SRO.

An SRO for state-regulated investment advisers is a misguided solution to a problem that doesn't exist. There is no evidence suggesting that states have failed in their mission of regulating smaller investment advisers.

We look forward to working with Congress in the months ahead to arrive at a legislative solution that benefits investors without exposing small and mid-sized investment advisers to redundant regulation and imposing job-killing costs on these small businesses to support a new regulatory regime.

What's Inside

Executive Director's Message: **Russ Iuculano**

Throughout our recent Public Policy Conference we heard a consistent theme: These are challenging times for investors and regulators alike.

Among the greatest challenges facing state securities regulators is the Investment Adviser Oversight Act of 2012 (H.R. 4624), introduced by House Financial Services Committee Chairman Spencer Bachus (R-AL) on April 25.

This bill would require state and federally registered investment advisers to become members of a self-regulatory organization (SRO). State securities regulators have a great deal at stake in this legislation and we must do all we can to make sure Congress gets it right and does not allow this attack on our system of federalism.

The bill has many critical flaws, (see page 7), only one of which is the requirement that all state investment advisers join an SRO. Also concerning is the bill's inflexible mandate that the SRO can examine state-regulated investment advisers unless the state "has adopted a plan to conduct an on-site examination of all such investment advisers on average at least once every four years…."

The June 6 House Financial Services Committee hearing on this bill raised more questions than answers about how the costs of the proposed SRO would impact small investment advisers. Questions also arose regarding the constitutionality of the bill's requirement that state agencies report to an industry-funded SRO.

During our Public Policy Conference, we were pleased that our keynote speaker, Rep. Maxine Waters, (D-CA), the second-highest ranking Democrat on the House Financial Services Committee, declared her opposition to H.R. 4624. An excerpt from her speech can be found on page 4.

Both at our conference and during the June 6 hearing, Rep. Waters said the best way to improve the oversight of federally registered investment advisers is to impose user fees on investment advisers to enable the SEC to conduct more frequent examinations.

We agree.

Investors Urged to Approach **Crowdfunding** with **Caution**

NASAA recently issued an advisory warning investors to approach crowdfunding investment opportunities with great caution.

Crowdfunding is an online money-raising strategy that began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and other creative people finance their projects. Through the Jumpstart Our Business Startups (JOBS) Act, small businesses and entrepreneurs will be able to tap into the "crowd" in search of investors to finance their business ventures.

"Because the potential for fraud is significant, investors must be extremely cautious about crowdfunding investments," said NASAA President Jack E. Herstein.

Congress enacted the JOBS Act in April and directed the Securities and Exchange Commission (SEC) to adopt rules within 270 days to implement a new exemption for crowdfunding. Until the rules are adopted, "any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws," according to a recent SEC release.

"Before the SEC rules are adopted, investors should beware of promoters who jump the gun by offering investments through crowdfunding now," Herstein said. "Once exempt, crowdfunding investments will not be reviewed by regulators before they are offered to the public, nor will they be required to provide the same level of disclosure to investors or regulators required for most securities offerings. Investors will need to prepare themselves to be bombarded with all manner of offerings and sales pitches."

New NASAA Task Force Focuses on Online & Crowdfunding Fraud

In anticipation of an increase in online fraud stemming in part from the JOBS Act, NASAA has created a new task force to focus on Internet fraud investigations.

Chaired by Minnesota Securities Director Robert Moilanen, the Internet Fraud Investigations Project Group will monitor crowdfunding and other Internet offerings. Other tasks will include coordinating multi-jurisdictional efforts to scan various online offering platforms for fraud, and, where authorized, coordinating investigations into online or crowdfunded capital formation fraud.

NASAA Member Elected to Leadership Team of SEC Investor Advisory Committee

Iowa securities regulator Craig Goettsch was elected Vice Chair of the Securities and Exchange Commission's (SEC) Investor Advisory Committee during the committee's inaugural meeting on June 12.

Goettsch is Securities Counsel and Director of Investor Education and Consumer Outreach for the Iowa Insurance Division's Bureau of Securities. In addition, he is a former NASAA President, Board member and Treasurer.

"NASAA is honored to serve on the Investor Advisory Committee and we look forward to helping to ensure that the voices of Main Street investors are heard as the SEC moves forward with its critical investor protection mission," said NASAA President Jack E. Herstein.

State Task Force Finds Insurance Firm Acted as Unlicensed BD/IA

A joint investigation by a task force of state securities regulators recently determined that Bankers Life and Casualty Co., an Illinois insurance firm, had been acting as an unlicensed broker-dealer and investment adviser.

"This joint investigation is typical of the aggressive, cooperative and coordinated investor protection actions of state securities regulators and demonstrates the ongoing value of states working together to benefit investors nationwide," said NASAA President Jack E. Herstein.

The Chicago-based company agreed that it, along with its BLC Financial Services, Inc. (BLCFS) subsidiary, will not engage in the hiring, training or supervision of any registered representatives or investment adviser representatives through March 31, 2015.

Bankers Life also agreed to withdraw the registration of its brokerage subsidiary with the Securities and Exchange Commission and terminate its membership with FINRA.

"This action resulted from a multi-state investigation of Bankers Life led by the Office of Securities of the Maine Department of Professional & Financial Regulation with invaluable assistance from the Bureau of Securities Regulation of the New Hampshire Department of State, the Division of Securities of the Missouri Office of the Secretary of State, and the Vermont Department of Financial Regulation," Herstein said.

"NASAA applauds their efforts to bring this matter to a swift resolution," Herstein said.

Keynote Speech: Rep. Maxine Waters

Waters on IA SRO: "I don't believe creating one or more new SROs is the best option."

As state regulators you are the real cops on the beat for securities fraud, taking the lead role in protecting retail investors on a day-to-day basis.

During the 112th Congress, the Financial Services Committee's attention has been squarely focused on monitoring the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

What we are seeing is a move beyond oversight of the implementation process and toward efforts to actively dismantle Wall Street Reform through a variety of tactics. First, we have seen wholesale attempts to undo provisions in the law. In addition to these broader efforts, we have seen a glut of smaller bills just meddling with Dodd-Frank.

It's obviously a very volatile time when you consider how the full landscape of Dodd-Frank regulations will ultimately resolve itself, and during all of this, we passed the JOBS Act.

Now, I must admit, I voted for the JOBS Act, but I have said and I keep saying, it was a leap of faith for me. My general disposition, which has only been heightened by the 2008 financial crisis, is that I am very worried about deregulation and even more skeptical of exotic products that offer the promise of financial innovation.

But at the same time, I am struggling with the challenges I face in my district where a large number of my constituents are underbanked or even unbanked, without access to mainstream credit. Balancing these two concerns, I tried to improve the various titles in the JOBS Act to enhance investor protection to the greatest extent I was able to.

We were unable to get everything we wanted. I appreciate that the Senate was able to add additional provisions; however, it would be foolish for me to say that I think the bill is perfect. On the crowdfunding title, I am concerned about the provision that preempts your ability to review offerings or require disclosures. The lesson I learned from the subprime crisis and the preemption of state predatory lending laws by the Office of the Comptroller of the Currency was that it led to a decrease in consumer protection, particularly in states where the laws were strong.

I can assure you that in my role on the committee, I will be vigilant in tracking the laws' implementation and impact. I will also be watching to make sure that the SEC works closely with the states pursuant to the Act as they write rules for crowdfunding. Since you will be the first responders to any fraud that occurs, the SEC should partner with the states in crafting the rules that will govern this new marketplace.

Another issue before our committee is Chairman Bachus' bill that would shift the oversight of investment advisers away from the SEC to one or more self-regulatory organizations.

I think everyone agrees that the status quo is not acceptable over the long term. The SEC is underfunded and simply doesn't have the resources to examine investment advisers with the frequency and depth that Congress and the investing public expects, but I think we should also recognize that this is a problem that Congress expressly created by failing to provide the SEC with adequate resources.

My optimal solution is for the appropriators to fund a robust SEC that can carry out the mandate that we entrusted with them. Of course, as the SEC study notes, another way of getting at this goal is to provide the SEC with the ability to impose user fees on investment advisers to fund their inspection and examination by the Commission, provided that these user fees are only used to fund regulation of investment advisors and not to subsidize other functions at the Commission. I think this option offers the best chance of enhancing the oversight of advisors.

In addition, I believe this option would be more cost effective for the industry. A reasonable user fee assessed by the SEC would be, by most accounts, substantially less than one assessed by any SRO.

While I believe that the Chairman's bill is a good-faith attempt to increase the number and frequency of examinations on an industry that's been underscrutinized, I don't believe that creating one or more new self-regulatory organizations is the best option. Besides the cost to industry, I am concerned about the cost to the SEC to oversee the activities of a new SRO, particularly in light of all the other responsibilities we placed on them under Dodd-Frank.

With regard to the role of the states, I am concerned that the bill would move to nationalize small and mid-sized investment adviser regulation. This is despite the fact that the states haven't done anything to demonstrate that they shouldn't be trusted to regulate these investment advisers. Given that the changes we made under Dodd-Frank to expand the role of state investment adviser examination and enforcement have just taken effect, it is premature to say we need new self-regulatory organizations looking over your shoulder.

BELOW: NASAA President-elect Heath Abshure moderates a panel of legal and industry experts in a discussion of the impact of the JOBS Act on investor protection and capital formation. From left: Robert Pozen, senior lecturer of business administration, Harvard Business School; William Black, associate professor of economics and law, University of Missouri-Kansas City School of Law; Lynn Turner, managing director, LitiNomics, and former SEC chief accountant; Jeffrey Mahoney, general counsel, Council of Institutional Investors; and Arkansas Securities Commissioner Abshure.

ABOVE: New York Investor Protection Bureau Chief Marc Minor listens as Mitchell Bompey (left) of Morgan Stanley Smith Barney outlines the firm's social media practices. Other panelists included Scott Peterson, co-founder of Relay Social Media LLC, and Thomas Selman, executive vice president of regulatory policy, FINRA.

SEC Commissioner Aguilar Praises the Collaborative Work of NASAA Members and SEC to Protect Investors

Adapted from May 14 remarks to NASAA by SEC Commissioner Luis Aguilar.

At a time when regulators are under greater constraints than ever, it makes sense for us to come closer together to further our common goals.

I want to start with an example where the SEC and NASAA staffs have already devoted enormous time and resources, and where the effects are obvious. The oversight of investment advisers has always been a partnership between state and federal regulators.

Congress reinforced this when it enacted Section 410 of the Dodd-Frank Act to expand state authority to include mid-sized investment advisers with $25 million to $100 million in assets. The smooth transition related to new registrants and changes in registration thresholds for investment advisers can only be possible because of the tremendous work done, and continuing to take place, of the SEC and NASAA staffs.

A new opportunity to work together has arisen from the recently passed Jumpstart Our Business Startups (JOBS) Act. I am referring to the explicit Congressional mandate that the states be consulted on the crowdfunding provisions that are contained in the bill. Specifically, the statute requires that the Commission consult with the state securities regulators on the rules that are required to implement the crowdfunding provisions of the JOBS Act.

This is an opportunity for the Commission to engage with the states and set up a process to make sure that the rulemaking benefits from the input of everyone involved.

My expectation is that the SEC staff will design a process that incorporates NASAA from the beginning and that the process will produce a truly collaborative product.

It is important that this mandated cooperation and collaboration is not undercut or subsumed by the deadline contained in the statute.

All of the topics I have discussed today are important initiatives where the public will be better served by greater collaboration and cooperation between federal and state regulators.

These are challenging times where investor protection feels like an uphill battle. In order to win the war, federal and state regulators must work together to pool resources and ideas to serve the public to our fullest ability.

Now, more than ever, the American public needs its regulators to be vigilant and pro-active.

JOBS Act Relaxs Investor Safeguards

The Jumpstart Our Business Startups (JOBS) Act was passed by Congress on March 27, 2012 and was signed into law by President Obama the following week.

This legislation relaxes important investor protections implemented in response to major financial scandals such as Enron and WorldCom. It dilutes reforms enacted as part of the Dodd-Frank Act in response to the 2008 financial crisis. It also eases already lax restrictions on private placements and legalizes so-called "crowdfunding" securities transactions (over which the SEC was given broad rulemaking authority).

The implications of the JOBS Act, in particular preemption of state law over crowdfunding, may have far-reaching, detrimental consequences to Main Street investors and the U.S. public.

Below is a summary of the five titles of greatest concern to state securities regulators.

> ***"The JOBS Act is an investor protection disaster waiting to happen."***
>
> NASAA President Jack E. Herstein

Title I: Reopening American Capital Markets to Emerging Growth Companies

- Allows all but the very largest companies direct access to capital from unaccredited retail investors without being required to provide the usual types of financial and risk disclosures applicable to public reporting companies.

- Rolling back these requirements and exempting all but the largest companies from SOX auditing requirements will hinder investors' ability to receive reliable financial information.

Title II: Access to Capital for Job Creators

- Allows, under Rule 506 of Regulation D, the general solicitation of, and widespread advertising to, all investors (including non-accredited investors), so long as the actual sale is made to accredited investors.

- Allows, under Rule 144A, the general solicitation of, and widespread advertising to, persons other than qualified institutional investors, so long as the actual sale is made to qualified institutional investors.

- Exempts from registration as a broker or dealer any person acting as an intermediary for Rule 506 offerings.

- Allowing general solicitation and widespread advertising to all investors, particularly with respect to Rule 506 offerings, may lead to increased investor abuse.

- Intermediaries relying on this exemption may be subject to recurring conflicts of interest among themselves, issuers and investors and may improperly promote certain offerings over others.

Title III: Capital Raising Online While Deterring Fraud & Unethical Non-Disclosure (CROWDFUND)

- Creates a new exemption under the Securities Act to facilitate the practice of "crowdfunding" in which securities are publicly sold in small amounts to a large number of small investors.

- Establishes an aggregate annual offering cap per issuer of $1 million, and an individual annual investment cap, per issuer, of (a) the greater of $2,000 or 5% of annual income or net worth if the investor has less than $100,000 in income or net worth, or (b) 10% of annual income or net worth, not to exceed $100,000, if an investor has at least $100,000 in income or net worth.

- Securities sold in reliance upon the crowdfunding exemption are given the status of "covered securities," so states retain only antifraud authority. States also retain antifraud authority over funding portals but are otherwise prohibited from regulating them, provided they comply with federal requirements.

Title IV: Small Company Capital Formation

- Raises the offering limit from $5 million to $50 million in any 12-month period for non-public companies using an exemption from registration under SEC Regulation A or a new similar exemption.

Title V: Private Company Flexibility and Growth

- Raises the shareholder threshold for triggering mandatory registration under Section 12(g) of Securities Exchange Act of 1934 from 500 to 2,000 shareholders (or 500 unaccredited shareholders). An issuer must continue to have total assets exceeding $10 million in order to meet the mandatory registration threshold.

- The increased threshold allows more private companies to avoid becoming public reporting companies and to rely on exemptions (e.g., Rule 506 of Regulation D) from registration when issuing shares.

NASAA Outlines Major Flaws in IA SRO Bill

State-registered investment advisers should not be required to become members of an SRO.

Requiring state-registered investment advisers (IAs) to become members of an SRO in states where these firms are already adequately regulated is unnecessary and will harm small businesses.

This mandate will have the effect of placing a ***costly new burden on thousands of small and mid-sized IAs*** (the majority of whom are one-and two-person shops). Under the bill, most of these firms will receive no benefit from their membership in the SRO as they will continue to be primarily regulated and examined by the states.

Imposing an additional layer of bureaucracy runs contrary to the many recent attempts by Congress and by the Financial Services Committee to support small business and reduce regulatory hurdles.

In fact, many small businesses are likely to be harmed or even put out of business by the costs associated with joining an SRO.

States' track record in examining small and mid-sized IAs with less than $25 million in assets under management is exemplary and that performance was recognized and validated by Congress when the Dodd-Frank Act expanded the states' oversight role. State securities regulators are prepared to take on this additional oversight, and have already put into place new resources to meet this responsibility.

States should be able to adopt examination practices best suited to their pool of IAs.

The four-year on-site examination requirement ignores the reality that IAs vary significantly in the size and types of businesses they conduct.

Some manage and maintain custody of sizable client assets while others don't actively manage any assets, but instead develop sophisticated financial plans for their clients.

These differences play a key role in determining the amount of risk posed by an IA's business. States have extensive experience designing examination programs to account for these variables and differences in risk profiles.

Requiring regulators to visit every IA on a four-year cycle may actually undermine investor protection by forcing regulators to overemphasize one component of risk instead of effectively accounting for all components of an investment adviser's business.

The regulatory flexibility of the states to do what is in the best interest of investor protection within their own borders should not be supplanted by a federally-mandated "one size fits all" standard.

State securities regulators should not be required to report to an SRO.

H.R. 4624 would require state securities regulators to report to an industry-funded SRO overseen by the SEC.

States are sovereign, independent entities, and should not be subordinated to a private, industry-funded corporation. Such a regulatory structure would compromise the independence and flexibility that are essential to effective state regulation. It would also ignore fundamental democratic principles from which regulation derives legitimacy.

Even though the majority of the SRO's membership would likely be state-registered IAs prohibited from registering with the SEC under section 203A of the Investment Advisers Act of 1940, H.R. 4624 gives the SEC exclusive oversight of the SRO for purposes of approving its rules and hearing appeals involving the discipline of its members.

State regulators are given no role in overseeing the SRO. Moreover, because decisions of the SRO would be appealable to the SEC rather than a state securities regulator, the SEC becomes the final arbiter of actions against persons (state-regulated investment advisers) that it does not regulate.

The bill's most burdensome and unwarranted requirement calls for the SRO to hold an "Annual Conference" with NASAA to determine which states are meeting the exam standards prescribed in the bill, and then submit a report to Congress.

The regulatory scheme proposed in this bill whereby the principal regulator—in this case state regulators—is subordinated to a private organization is ***an attack on the principles of federalism and state sovereignty established in the Constitution.*** States, like the federal government, are statutory regulators and accordingly should not be subordinated to an industry self-regulator.

The exemptions in H.R. 4624 undermine the legislation's goal and purpose.

In many ways, the bill fails to address or remedy the problems that were the core focus of the SEC's Section 914 study. If the bill's rationale is to "augment and supplement the SEC's oversight to dramatically increase" its examination rate for IAs with retail customers, ***the many exemptions in the bill need substantial narrowing.*** The bill exempts major categories of SEC-registered advisers from SRO membership including advisory firms with at least one mutual fund client, regardless of the amount of assets the adviser has under management, and advisory firms with at least 90% of its assets attributable to institutional and high net worth clients or private funds.

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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.

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NASAA Offers Recommendations to Increase Investor Use of BrokerCheck

In an April 27 comment letter, NASAA offered a series of suggestions to assist FINRA in its efforts to increase investor use of information found on BrokerCheck.

Through the online BrokerCheck program, FINRA releases to the public background information about brokers reported on uniform registration forms to the Central Registration Depository (CRD).

"NASAA is encouraged by FINRA's efforts to increase transparency and improve the BrokerCheck system," said NASAA President Jack E. Herstein.

"Currently, there is a gap between the information that is provided in BrokerCheck reports and CRD snapshot reports provided to the investing public by state securities regulators," Herstein said.

NASAA's comment letter said BrokerCheck system reports should include all of the information that a CRD snapshot would provide, absent a compelling reason to do otherwise.

For example, NASAA believes that BrokerCheck reports should include a broker's educational background, continuing education history, and CRD/IARD filing history as well as the reason for and comments related to a broker's termination.

NASAA also believes that FINRA should discontinue the practice of placing time limits on disclosure, such as the 10-year limit on the inclusion of bankruptcies in BrokerCheck reports.

NASAA also suggested that BrokerCheck enhance information available about arbitration proceedings involving allegations of sales practice violations. Currently, BrokerCheck provides a link to arbitration awards but this is limited to final awards against associated persons.

"NASAA urges FINRA to expand the information to include statements of claim, answers, and the final decision regardless of whether a complainant has received a favorable ruling. Similar information involving civil litigation is publicly available in courthouses across the country," Herstein wrote.