



VIA ELECTRONIC MAIL

July 31, 2020

Karla Black, Chair of the Restitution Assistance Working Group (karla.black@maine.gov)
Lynne Egan, Chair of the State Legislation Committee (legan@mt.gov)
NASAA Corporate Office (nasaacomment@nasaa.org)

Re: **NOTICE OF REQUEST FOR PUBLIC COMMENTS ON PROPOSED MODEL ACT TO
CREATE A STATE RESTITUTION FUND FOR VICTIMS OF SECURITIES VIOLATIONS**

Dear Ms. Black and Ms. Egan:

On June 30, 2020, the North American Securities Administrators Association (NASAA) released for public comment a Notice of Request for Public Comment on Proposed Model Act to Create a State Restitution Fund for Victims of Securities Violations, “to provide financial assistance to victims of securities law violations who were awarded restitution but have not received full payment.” (“Model”).¹ The Model was developed by NASAA’s Restitution Assistance Working Group.

The Financial Services Institute² (FSI) appreciates the opportunity to comment on this important proposal. FSI is concerned that despite its well-intended purpose, the Model could create perverse incentives that will perpetuate bad conduct and invite excess litigation and arbitration. As discussed below, FSI believes the cost of restitution must be borne by those who violate securities laws and cause harm and loss to investors. Any shift of burden away from the responsible party risks creating a perverse incentive for abusive conduct. We note the Model’s provisions to disqualify persons who participated in securities law violations and sections relating to subrogation, liens, caps, and the refund of excess restitution can mitigate some of the potential harms. However, we believe the moral hazard that the Model would create is substantial and we therefore oppose its adoption.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing

¹ Notice of Request for Public Comment on Proposed Model Act to Create a State Restitution Fund for Victims of Securities Violations. <https://www.nasaa.org/wp-content/uploads/2020/07/Model-Restitution-Assistance-Legislation-Request-for-Public-Comment.pdf>

² The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

registered representatives.³ These financial advisors are self-employed independent contractors, rather than employees of the dually registered Independent Broker-Dealers (IBD) and Registered Investment Adviser (RIA) firms through which they are licensed.⁴

FSI's member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

Discussion

FSI appreciates the opportunity to comment on the proposed Model. We firmly believe that restitution must come from the persons and/or entities responsible for the victim's losses and that the existence of a fund may have the consequence of increasing frivolous or unfounded claims. For that reason, FSI opposes the adoption of the NASAA Model. However, if NASAA does move forward with the Model and states choose to adopt the Model or otherwise establish restitution funds, we offer the following comments to help mitigate potential perverse incentives and abuses resulting from the existence of a fund. We also address the concern over funds potentially unfairly shifting restitution to responsible, ethical financial professionals, and taxpayers.

I. The Restitution Assistance Fund

The Model establishes a restitution assistance fund, with the purpose of "provid[ing] financial assistance to victims of securities law violations who were awarded restitution but have not received full payment." The state fund is "for victims that were awarded restitution in a final order" and who "have not received the full amount of restitution...".⁵

Investors should have confidence that if they suffer harm as a result of wrongdoing that they have a mechanism for redress and an opportunity to be made whole. That confidence can be undermined when an advisor or firm are found to have acted unlawfully, but the investor is unable to recover some, or all, of an award of restitution. While there is no guarantee that investors will always be made whole, together a system which includes arbitration, litigation, administrative enforcement actions, Securities Investor Protection Corporation and fidelity bond coverage has served to mitigate investor losses.

³ Cerulli Associates, Advisor Headcount 2016, on file with author.

⁴ The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a dually registered representative of a broker-dealer and an investment adviser representative of a registered investment adviser firm. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

⁵ Notice of Request for Public Comment on Proposed Model Act to Create a State Restitution Fund for Victims of Securities Violations, Section 3.

In proposing the Model, no data is offered to establish that non-payment of restitution awards is a significant problem that warrants the establishment of a restitution assistance fund. We can look to FINRA which has studied non-payment of arbitration awards. FINRA found that only 2% of awards go unpaid,⁶ which suggests that non-payment is uncommon. In absence of data establishing a clearly identified, substantial problem, we believe the Model cannot be justified given the potential negative consequences of a restitution assistance fund.

Bad actors must know clearly that they are responsible for the consequences of their own malfeasance. Knowing that their clients can be compensated by others in the industry or by taxpayers may create a perverse incentive to engage in or to prolong abusive conduct, thus undermining investor protection.

We are also concerned that the restitution assistance fund will incentivize excessive arbitration or litigation. The existence of the fund could also serve as an incentive for claimants to bring unfounded or frivolous claims, knowing that regardless of the outcome, if the firm is no longer in business for any reason, the claimant will have access to funds. Without the restitution fund there is greater incentive to promptly bring an action when misconduct occurs, increasing the likelihood of recovery and minimizing investor harm.

Overall, FSI believes that despite the well-intended goal of helping investors who have been harmed, the creation of a restitution assistance fund creates a moral hazard that may ultimately be harmful to investors.

II. Funding Sources

Section 4 of the Model relates to the source of funding for the restitution assistance fund. It is an open provision, allowing each adopting state to determine its funding source(s). The Model's Prefatory Notes do not make any recommendations to the adopting states but does identify six "possible" sources. The six sources are drawn from the five states which informed the Model's drafting.⁷ The sources cited including funding from fines and penalties, appropriations by the state legislature, contributions, and licensing and registration fees.

With different funding sources in use or proposed and the variability of state laws, we understand why the Model does not specify a particular funding source. In fact, the few states that have a restitution fund have multiple funding sources. However, FSI strongly recommends that if NASAA moves ahead with the Model, that it reflect a clear policy preference that fines and penalties be the sole funding source for the state restitution assistance funds.

It is manifestly unfair to the vast majority of financial professionals and firms conducting themselves ethically and responsibly, to ask them to compensate for the misconduct of others. Likewise, taxpayers should not be forced to pay for the misconduct of others. As with the creation of the fund itself, funding by sources other than those violating securities laws and rules creates a moral hazard which is likely to incentivize and perpetuate misconduct.

⁶ Member Firms and Associated Persons with Unpaid Customer Arbitration Awards <https://www.finra.org/arbitration-mediation/member-firms-and-associated-persons-unpaid-customer-arbitration-awards#4>

⁷ The Model draws on funds established or proposed in Indiana, Montana, Vermont, Kansas and Maine.

FSI firmly believes that the Model can and should identify fines and penalties as the sole source of funding for a state restitution assistance fund. From a public policy perspective, it is clearly the best approach. It can be offered with minimal disruption to current state laws. We believe Montana is the only state with an existing restitution fund⁸ that designates a portion of licensing and registration fees for deposit in such fund.⁹ But, it is worth noting that fines are also used to maintain Montana's fund and that the funding from licensing and registration fees will be sunset in 2021.¹⁰

Given the potential negative policy implications of using registration and licensing fees as a source for the restitution assistance fund and the fact that the only state currently with such a funding source is set to stop dedicating those fees in 2021, we recommend that the Prefatory Note exclude funding from these fees among the options proffered. However, if NASAA deems it necessary to include the option, FSI suggests that fuller context be added. Such context should include notations that such fees are not the exclusive or primary source of funding in the states cited, that Montana's provision is sunset, and that Maine's proposal is qualified (see Footnote 8).

III. Disqualifications

Though FSI opposes adoption of the NASAA Model at this time, we wish to note portions of the Model that we believe are essential for any state that seeks to establish a restitution fund.

Sections 8 and 10 of the Model provide for prohibition or forfeiture of restitution of funds where a recipient or potential recipient has engaged in misconduct in connection with the claim.

FSI supports these provisions as essential and appropriate to further purpose and integrity of the restitution assistance fund. These sections also help avoid incentivizing improper conduct.

IV. Purpose and Financial Viability

Likewise, notwithstanding FSI's opposition to the Model we believe the purpose and long-term financial viability of the restitution assistance fund are ensured by sections 5, 7, 9, and 11 through 15 of the Model. FSI strongly supports these provisions which among other things:

- Secure the funds exclusively for the purpose of restitution;
- Limit payout of claims to ensure financial viability and avoid improper incentive;
- Allow for recovery of excess payouts;
- Provide mechanism for the recovery of funds from the person or firm that have engaged in misconduct; and
- Limit payouts if the fund balance is too low.

⁸ The Prefatory Notes reference Maine LD 1704 (2019-2020 legislative session), which has not been enacted. LD 1704 provides that \$5 of a broker-dealer agent or investment adviser representative fee will be deposited in the restitution fund if the Office of Securities' funds exceed 135% of its budget. Fines are the primary source of funding under LD 1704.

⁹ 30-10-1004(2)(a)(i), M.C.A.

¹⁰ 30-10-209(6)(b), M.C.A.

Together, these provisions further the purpose of the restitution assistance fund, preclude use of the funds for other purposes, provide a mechanism to hold bad actors accountable and ensure the financial viability of the fund.

Conclusion

FSI opposes NASAA's proposed model act creating a state restitution assistance fund. The Model is well-intended in its purpose of providing financial assistance to victims of securities law violations who were awarded restitution but have not received full payment. However, we believe a substantial problem has not been established that would justify the potential risks of creating state restitution funds, including incentivizing excessive litigation and arbitration, creating a moral hazard that would put investors at greater risk, and penalizing honest financial professionals and taxpayers. FSI is committed to constructive engagement with NASAA to address the issue of non-payment of restitution awards and respectfully suggest that NASAA not adopt the Model at this time.

If NASAA decides to adopt the Model, FSI suggests that funding should come from fines and penalties assessed against those who have violated the states' securities laws and reinforce the importance of including Sections 5 and 7 through 15. We strongly recommend that the model reflect these policy goals.

Thank you for considering our comments. Should you have any questions, please contact my colleague Dan Barry at (202) 517-6464, or dan.barry@financialservices.org.

Respectfully submitted,

A handwritten signature in blue ink that reads "Robin M. Traxler". The signature is fluid and cursive, with a long horizontal stroke at the end.

Robin Traxler
Senior Vice President, Policy & Deputy General Counsel