Written Testimony of David Massey
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"Enhanced Investor Protection After the Financial Crisis"
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Chairman Johnson, Ranking Member Shelby, and members of the Committee, I'm David Massey, Deputy Securities Administrator for North Carolina and President of the North American Securities Administrators Association, Inc. ("NASAA"). I am honored to be here today to discuss how the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is providing enhanced protection to investors, particularly Main Street Americans who are looking to lawmakers and state and federal regulators to help them rebuild and safeguard their financial security.

The Wall Street reforms and investor protection provisions in the Dodd-Frank Act were born out of necessity. The financial crisis made it clear that the existing securities regulatory landscape required an overhaul. NASAA sincerely appreciates the work of Chairman Johnson and members of this committee to ensure that investor protection remained the foremost goal of the legislative effort to usher in the next generation of financial services regulation.

This comprehensive law was crafted to promote stronger investor protection and more effective oversight to help prevent another economic crisis and restore the confidence of Main Street investors. The Dodd-Frank Act addresses a number of critical issues for investors by incorporating disqualification provisions to prevent securities law violators from conducting securities offerings under SEC Regulation D, Rule 506; strengthening the accredited investor standard; and increasing state regulatory oversight of investment advisers. Dodd-Frank also includes a provision to safeguard senior investors from unqualified advisers and creates an investor advisory committee to advise the SEC on its regulatory priorities. In two other priority areas for investors, fiduciary duty and arbitration, the law authorizes the SEC to take action to provide enhanced protections and remedies for investors.

Role of State Securities Regulators

State securities regulators have protected Main Street investors from fraud for the past 100 years, longer than any other securities regulator. From the enactment of the first blue sky securities law in Kansas in 1911, state securities regulators continue, more so than any other kind of regulator, to focus on protecting retail investors. Our primary goal has been and remains to advocate and act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

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 your constituents. Like me, ten of my colleagues are appointed by state Secretaries of State, five come under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others work for independent commissions or boards. Many call us "local cops on the securities beat." I think of my state colleagues at NASAA as a national network of local crime fighters working to protect investors.

Securities regulation is a complementary regime of both state and federal securities laws, and we work closely with our federal counterparts to uncover and prosecute violators of those laws.

States have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious jail time for securities-related crimes. Over the past few years, ranging from 2004 through 2009, state securities regulators have conducted nearly 14,000 enforcement actions, which led to $8.4 billion ordered returned to investors. And, we have worked to secure convictions for securities laws violators resulting in more than 6,000 years in prison.

Traditionally, state securities regulators have pursued the perpetrators at the local level who are trying to defraud the "mom and pop" investors in your states. That allows the SEC to focus on the larger, more complex fraudulent activities involving the securities market at a national level.

Even so, states have successfully exposed and addressed the 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. And state securities regulators continue to lead the nationwide effort to address problems related to the offer and sale of auction rate securities, an effort that has resulted in the largest return of funds to investors in history. As regulators, we are convinced that every investor deserves protection and an even break.

Enhanced Investor Protections in Dodd-Frank

As we enter our second century of investor protection, state securities regulators are at the forefront of investor protection. By passing and signing the Dodd-Frank legislation into law, President Obama and Congress signaled the beginning of a new era of investor protection and financial market oversight. Reforms now taking shape at the national level are giving new authority to state securities regulators to address the challenges facing 21st century investors.

Trust in the markets must be restored if our system of capital formation is to thrive. The Dodd-Frank Act helps restore investor trust by enacting a number of much-needed investor protections that empower state securities regulators to protect citizens from fraud and abuse in the financial markets.

Reducing Investor Risk in Rule 506 Offerings

Section 926 of the Dodd-Frank Act took a necessary first step toward reducing risks for investors in private offerings by requiring the SEC to issue rulemaking excluding securities law violators from utilizing the Regulation D, Rule 506 exemption ("Rule

506”) from securities regulation. In 1996, the National Securities Markets Improvement Act dramatically curtailed the authority of state securities regulators to oversee these unregistered private offerings. Rule 506 offerings are also exempted from federal oversight and the SEC generally does not review them, so they receive virtually no regulatory pre-screening.

These unregistered private offerings naturally have become a favorite vehicle for unscrupulous promoters, who use the Rule 506 exemption to fly under the radar. In 2009, more than 26,000 of these offerings were filed with the SEC with an estimated offering total of $609 billion. Section 926 took the important step of ensuring that promoters and brokers who have a criminal or disciplinary history will no longer be able to prey on investors by using this exemption from registration.

We appreciate the inclusion in the Dodd-Frank Act of the so-called “bad actor” disqualifier language to prevent recidivist securities law violators from conducting securities offerings under Rule 506. However, we continue to believe the best way to deter fraud is to fully reinstate state authority over these unregistered offerings through the repeal of Subsection 18(b)(4)(D) of the Securities Act of 1933. Allowing state securities regulators to review these offerings provides regulators with a powerful weapon to detect and prevent fraud.

As required under Section 926, the SEC recently proposed rules mandated by the Dodd-Frank Act to disqualify known securities law violators from using the exemption contained in Regulation D, Rule 506. The proposed rules protect investors without hampering legitimate capital-raising by disqualifying felons and other “bad actors” from evading registration and review. Under the proposal, an offering would not qualify for the exemption from registration if the company issuing the securities or any other person covered by the rule had a specified “disqualifying event.”

NASAA is a long-time supporter of the adoption of disqualification provisions for securities offerings under Rule 506. We commend the SEC for proposing disqualification provisions that are in line with many of our concerns and will continue to work with the SEC to strengthen the proposal.

Strengthening the "Accredited Investor" Standard

Private offerings were originally intended only for institutional investors and sophisticated individuals who were presumed capable of assessing risks and making investment decisions without the benefit of regulatory review and registration. The "accredited investor" standard, which sets out certain financial thresholds that must be met before an investor can purchase private offerings, was adopted as a means of assessing which investors could presumably fend for themselves. The standard as adopted by the SEC in 1982 has remained unchanged. Inflation has severely diminished the standard and eroded the investor protection goals it was meant to serve. To make matters worse, investors, and particularly retirees, with much of their net worth tied to their homes have been able to meet these diminished standards and purchase risky private placements that they may not fully understand.

NASAA has long advocated for adjusting the definition of "accredited investor" in light of inflation and has expressed concern at the length of time the thresholds contained in the definition have remained static.

Section 412 of the Dodd-Frank Act addressed this problem by adjusting the financial thresholds in the definition of an "accredited investor", and by removing the value of the investor's primary residence from the net worth calculation. Dodd-Frank also directs the SEC, four years after enactment, and once every four years thereafter, to review the definition of "accredited investor" to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy. Upon completion of the review, the SEC may adjust the other economic elements of "accredited investor".

Raising the standard for individual investors will provide greater protection for investors and will aid state regulators in enforcement activities by furthering more accurate suitability determinations for those individuals who choose to take greater risks by investing in unregistered securities.

Expanding State Oversight of Investment Advisers with the IA "Switch"

The oversight of investment advisers has always been a partnership between state and federal regulators, both of which are directly accountable to the investing public. Congress recognized the strong record of the states in this area when it enacted Section 410 of Dodd-Frank to expand state authority to include mid-sized investment advisers with $25 million to $100 million in assets under management.

By the time this provision takes effect in mid-2012, state securities regulators will oversee the majority of all registered investment adviser firms. Having the states assume responsibility for mid-sized advisers will allow the SEC to focus on larger advisers. Investors will benefit from this change because it will enable the SEC to focus on the largest investment advisers, while mid-sized and smaller advisers will be subject to the strong state system of oversight and regulation.

States continue to prepare to receive oversight of approximately 3,200 mid-sized investment advisers from the SEC. Over the past year, NASAA members have been hosting a series of workshops for investment advisers in their jurisdictions. This outreach program is helping to educate federally regulated advisers about state registration and examination requirements. In addition, NASAA developed a memorandum of understanding calling for state securities agencies, when necessary, to assist one another with examinations of investment advisers. This MOU embodies the long-standing practice among NASAA members to work together to protect investors. NASAA members are actively engaged in sharing resources, including staff expertise, in an effort to bolster examination programs.

Last month, the SEC extended its timeline for this "investment adviser switch" from later this year into the middle of 2012 to accommodate the reprogramming of the Investment Adviser Registration Depository (IARD) system and to give investment advisers sufficient time to transition from SEC to state registration. NASAA remains committed to coordinating the actions of the states in response to the SEC's timetable and we will continue to work with the SEC, as well as industry, to see that the switch by investment advisers from SEC regulation to state regulation goes as efficiently and seamlessly as possible.

Extending the Fiduciary Duty

State securities regulators routinely see the financial devastation caused when the interests of investors do not come first. That is why NASAA has consistently urged policymakers to protect investors by requiring all who provide investment advice about securities to be held to the fiduciary duty currently applicable to investment advisers under the Investment Advisers Act of 1940.

Section 913 of the Dodd-Frank Act called for the SEC to examine the obligations of brokers, dealers, and investment advisers. We support the recommendations of the SEC staff report to apply a fiduciary duty to broker-dealers who provide personalized investment advice about securities to retail customers and believe it will have a significant positive impact on investors. NASAA looks forward to assisting the Commission as it develops rules to apply a fiduciary standard of care and loyalty to all who provide investment advice to ensure that this standard is as strong as the existing fiduciary duty of the Advisers Act.

Delays to Important Investor Protections

As with the fiduciary duty provision, Dodd-Frank shifts the ultimate responsibility to decide whether, and in what form, several important investor safeguards will be delivered. For example, the SEC and the Commodity Futures Trading Commission were given broad and sorely needed regulatory authority over certain segments of our marketplace, such as over-the-counter derivatives and private funds.

Yet in spite of their increased responsibility, the agencies are operating at inadequate funding levels. NASAA has consistently urged Congress to support funding the SEC at the level requested by the Administration so that the agency can fully implement its responsibilities mandated by Dodd-Frank. We support funding the SEC at the $1.3 billion level authorized by Dodd-Frank to carry out the functions, powers and duties of the Commission for FY 2011.

Giving Investors a Voice at the SEC

The SEC has already deferred action on a number of new activities, such as the creation of the Office of Investor Advocate and the Investor Advisory Committee. In 2009, the SEC established an Investor Advisory Committee to provide the Commission with a variety of viewpoints regarding its regulatory agenda. The committee included a state securities regulator, along with other investor advocates, to make certain that all SEC regulatory actions serve the best interests of investors.

This committee wound down in anticipation that legislation, ultimately the Dodd-Frank Act, would resurrect it under a statutory mandate. Indeed, Section 911 of the Dodd-Frank Act did require the SEC to establish and maintain a committee of investors to advise the SEC on its regulatory priorities and practices and also designated that a state securities regulator continue to serve as a member. SEC Commissioner Luis Aguilar recently said that this committee is of "critical importance to ensuring that the SEC is focused on the needs and the practical realities facing investors." Unfortunately, budget uncertainty has forced the SEC to defer the creation of the Investor Advisory Committee.

Providing Choice of Forum for Investors and Promoting Transparency

Every year thousands of investors file complaints against their stockbrokers. Almost every broker-dealer presently includes in their customer agreements a mandatory pre-dispute arbitration provision that forces those investors to submit all disputes that they may have with the brokerage firm or its associated persons to mandatory arbitration. If cases are not settled, the only alternative is arbitration. For all practical purposes, the only arbitration forum available to investors is one administered by the Financial Industry Regulatory Authority (FINRA).

Arbitration has been presented to the investing public as an inexpensive, informal, totally private process that results in a speedy resolution of cases. However, the mandatory arbitration provisions in contracts take away the ability of a harmed customer to “have their day in court” by forcing investors into a forum that limits discovery, reduces the pleading standards and allows decisions in which there is severely limited appeal. Arbitration as it exists does not treat the investing public fairly. If the system were a level playing field, arbitration probably would not be a universal requirement of the brokerage industry, and the investing public likely would embrace it voluntarily. Not surprisingly, studies have confirmed the belief that the securities arbitration forum is not perceived as fair to investors, and recovery rates in fact favor the securities industry.

In February, the SEC approved a FINRA rule proposal that would allow all investors filing arbitration claims the option of having an all-public panel, thus expanding a pilot program to all investor claims. Historically, the panels had been comprised of two public arbitrators and an arbitrator who had worked in the securities industry. The FINRA rule change was an important step toward leveling the playing field for investors and improving the integrity of the arbitration system. However, with the economy as it is today, investor confidence remains very low. Another major step in restoring investor confidence and industry integrity would be to restore investor choice in their agreements with their brokerage firm.

Section 921 of Dodd-Frank provides the SEC with rulemaking authority to prohibit, or impose conditions or limitations on the use of mandatory predispute arbitration agreements if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors. Pursuant to this provision, Congress should urge the SEC to use the authority provided the agency in Section 921 and impose rules prohibiting the mandatory nature of pre-dispute securities arbitration. This would allow investors the choice they ought to have between arbitration and litigation in an independent judicial forum.

Funding the Grant Program to Safeguard Senior Investors from Unqualified Advisers

One of the highest priorities of NASAA’s membership is to protect vulnerable senior investors from investment fraud. We have long been concerned with the use of misleading professional designations that convey an expertise in advising seniors on financial matters. Many of these designations in reality reflect no such expertise. Our concern led us to promulgate a model rule designed to curb abuses in this area, and 27 states have adopted rules or laws governing the use of these designations.

Section 989A of Dodd-Frank recognizes the harm to seniors posed by the use of such misleading activity and establishes a mechanism for providing grants to states as an incentive to adopting provisions meeting the minimum requirements of NASAA's model rule on the use of designations in the offer or sale of securities or investment advice. The law provides parallel incentives for states that have adopted provisions meeting the minimum requirements of the National Association of Insurance Commissioners' model rule on the use of senior designations in the sale of life insurance and annuities.

The grants are designed to give states the flexibility to use funds for a wide variety of senior investor protection efforts, such as hiring additional staff to investigate and prosecute cases; funding new technology, equipment, and training for regulators, prosecutors, and law enforcement; and providing educational materials to increase awareness and understanding of designations.

Unfortunately, disputes over the funding and leadership of the Consumer Financial Protection Bureau ("CFPB") not related to investor protection have indefinitely delayed the creation of the senior investor protection grant program under Section 989A. The CFPB Office of Financial Literacy must be fully funded and operational to begin issuing grants of up to $500,000 to states that have adopted the NASAA and NAIC model rules on misleading senior designations. These important senior investor protections should not be delayed because Congress has not provided sufficient funding for the federal financial regulatory agencies.

Conclusion

As discussed above, the Dodd-Frank Act provides meaningful, tangible benefits to investors. It requires the SEC to raise standards that are long overdue and blocks fraudulent actors from taking advantage of exemptions that should be reserved for reputable issuers. The Dodd-Frank Act empowers the SEC to raise the standards under which broker-dealers provide investment advice to ensure that the interests of investors come first. The law also recognizes the investor protection contributions of state regulators by increasing our authority over the regulation of investment advisers and by ensuring we have a voice on both the SEC's investor advisory committee and the Financial Stability Oversight Council. I am honored to serve on the FSOC along with my state banking and insurance colleagues. State regulators bring to the FSOC the insights of "first responders" who see trends developing at the state level that have the potential to impact the larger financial system.

I want to thank Chairman Johnson for his consistent support for the important investor protections included in the Dodd-Frank Act. I appreciate your comments, Senator Johnson, that it "would be dangerous and irresponsible," to rollback these hard-won reforms.

Our message to Congress is simple and clear: Please continue your commitment to protecting investors and do not undermine the Dodd-Frank Act's regulatory authority either directly through legislative repeals or indirectly through a lack of appropriate funding or delayed execution.

We look forward to working cooperatively with the Senate Banking Committee, as well as all members of Congress and fellow regulators to ensure full implementation of the investor protections included in the Dodd-Frank Act.