

# NASAA Insight

The Voice of State & Provincial Securities Regulation

Winter 2012



NASAA

## NASAA Testifies on Small Business Capital Formation

In testimony before the Senate Banking Committee, the North American Securities Administrators Association (NASAA) said state securities regulators are best positioned to provide an efficient regulatory framework to enable new and small businesses to raise investment capital and provide safeguards for investors.

"NASAA firmly believes that the states should be the primary regulator of small business capital formation, including crowdfunding offerings," said Jack E. Herstein, NASAA President and Assistant Director of the Nebraska Department of Banking & Finance Bureau of Securities.

"Because we realize that small businesses are vital to job growth and improving the nation's economy, state



NASAA President Jack E. Herstein of Nebraska testifies at a December 1, 2011 hearing focused on legislation to spur job growth through capital formation.

securities regulators have no interest in throwing up needless roadblocks for small businesses," Herstein said. "Instead, we are interested in creating ways to spur economic development and job creation."

Herstein's testimony came during a December 2011 hearing focused on legislation to spur job growth through capital formation. A package of related legislation recently passed the House of Representatives and companion bills have been introduced in the Senate.

Herstein's testimony focused largely on H.R. 2930 and S. 1791, both of which would

promote the use of Internet-based "crowdfunding" websites to allow individuals to invest in entrepreneurial start-ups and small businesses.

[See page 4 >>](#)

## The Year of the Switch Has Arrived

The Dodd-Frank Act recognized the strong record of state securities regulators and gave NASAA members new authority to address the challenges facing 21st century investors.

By the middle of this year, for example, state securities regulators will see an increase of approximately 25 percent in the number of investment advisers subject to state regulation.

"This presents states with a unique regulatory challenge," said Jack E. Herstein, NASAA President and Assistant Director of the Nebraska Department of Banking & Finance Bureau of Securities.

"Fortunately, we have been preparing to meet this challenge for nearly two years and are ready for the switch. These preparations should enable us to implement intelligent, efficient and responsive regulation."

Throughout the United States, more than 400 experienced state employees are dedicated to investment adviser licensing and examination, including

field examiners, auditors, accountants and attorneys.

NASAA members are developing ways to maximize available resources. For example, each state has agreed to work together and share resources as needed to regulate the expanded state investment adviser population.

A new NASAA initiative (see page 6 for details) now enables regulators to review the applications of advisers required to register in four or more states in a coordinated manner as they switch from federal to state regulation.

NASAA also has invested in new tools that enable states to leverage their resources in the examination of investment advisers.

"We have developed uniform examination procedures to promote a consistent and high standard of examination at the state level and advanced risk-analysis software to allow states to rapidly review and rank their investment adviser registrants," Herstein said.

[See page 6 >>](#)

## From the Leadership

### President's Message: Jack Herstein



The closing months of the first session of the 112th Congress presented NASAA with multiple challenges to the regulatory authority of state securities regulators. As the second session gets underway, the political climate in Washington promises to be just as challenging.

A number of small business capital formation bills, including several that would establish a registration exemption for "crowdfunding," are likely to receive much attention from the Senate over the next several months. And NASAA and its members will take every step to ensure that state regulatory authority is preserved and that investor protection is balanced with legitimate capital formation.

My colleagues and I are acutely aware of the present economic environment and its effects on job growth. We understand the vital role small businesses play in the national economy, and many of our agencies have adopted measures to facilitate access to capital by small businesses in ways that directly protect both the businesses and investors engaged in this segment of the market.

In December, I testified before the Senate Banking Committee during a hearing on the five pending Senate bills regarding capital formation. I outlined the three principles that guide NASAA's thinking in this area.

- First, Congress should refrain from preempting state law.
- Second, while the desire to facilitate access to capital for new and small businesses is warranted, Congress must be sure to do so in a careful and deliberate manner.
- Third, Main Street investors should not be treated as the easiest source of funds for the most speculative business ventures.

Balancing the needs of small businesses and investors requires a degree of regulatory flexibility and creativity that is the hallmark of state securities regulation. This is why we believe that states should remain the primary regulator of small business securities offerings, including crowdfunding offerings.

Moving forward, we will strive to continue to strike an appropriate balance between cultivating innovation while protecting investors as we do our part to promote economic growth.

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### Executive Director's Message: Russ Iuculano



Amid the ongoing debate over various proposals to promote economic growth and encourage capital formation, states also remain laser focused on the upcoming switch of mid-sized federally registered investment advisers to state registration, scheduled to take place at mid-year.

NASAA's IA Switch Resource Center is the online home for the many resources available to IAs who are making the switch, including a calendar of state seminars and workshops and details on the new Coordinated Review Program (see page 6).

The goal of NASAA's IA outreach initiative is to prepare the industry for state oversight; enable new registrants to set up their operations properly in order to avoid inadvertent noncompliance; and to bring legitimate investment advisers, state regulators, and NASAA together, before the switch, so that all parties can establish a positive and constructive working relationship.

The state switch workshops have proven to be an effective way of educating and informing the regulated community and introducing IAs to state regulation and regulators. The new coordinated review program for switching advisers demonstrates state securities regulators' commitment to helping mid-sized advisory businesses navigate the switch. And to assist NASAA members with their examinations, NASAA recently launched the long-awaited NEMO (NASAA Electronic Examination Modules) software application, which will allow state examiners to perform broker-dealer and investment adviser examinations in a secure, digital environment.

By increasing state regulatory authority over investment advisers, Dodd-Frank recognized the distinguished record of NASAA members. NASAA has responded by investing in new tools to help our members demonstrate that this confidence is well placed.

## Chasing Higher Yield

*NASAA Cautions Investors Not to Stumble When Interest Rates Fall Flat*

Following the Federal Reserve's announcement that interest rates are expected to remain low until at least late 2014, NASAA cautioned investors to beware of risky or outright fraudulent investments promising higher yield or returns.

"Investors running away from low yields on fixed investment products risk stumbling into the arms of unscrupulous salespeople promising low risk and high returns," said Jack E. Herstein, NASAA President and Assistant Director of the Nebraska Department of Banking & Finance Bureau of Securities. "Don't chase the offer of high yield or returns into a dead-end investment."

Herstein said that state and provincial securities regulators are concerned that individuals who depend on fixed income investments, particularly seniors, may be tempted to turn away from their slower growing but safe investments to alternative investments without understanding the risks and terms.

"When evaluating any investment, it pays to remember that risk and reward go together," Herstein said. "Anyone promising high yield or high returns with little or no risk should be approached with a high degree of skepticism."

Herstein noted that yield-starved investors may be more easily enticed into fraudulent schemes that can be cloaked as private placement offerings, promissory notes, securitized life settlement contracts and investments in energy, precious metals and distressed real estate, all of which are contained in NASAA's current list of Top Investor Traps.

Before purchasing any investment, NASAA reminds investors to ask the following questions:

- **Are claims made for the investment realistic?** Use common sense and get a professional, third-party opinion when presented with investment opportunities that seem to offer unusually high returns in comparison to other investment options.
- **Has the seller given you written information that fully explains the investment?** Request written information that fully explains the investment, such as a prospectus or offering circular. The documentation should contain enough clear and accurate information to allow you or your investment adviser to evaluate and verify the particulars of the investment.
- **Are the seller and investment licensed and registered in your state?** Call your state or provincial securities regulator to find out. If they are not, they may be operating illegally.

## Taking Aim at Fraud Targeting the Military

NASAA encouraged military members and their families to shore up their defenses against investment fraud during Military Saves Week (February 19-26).

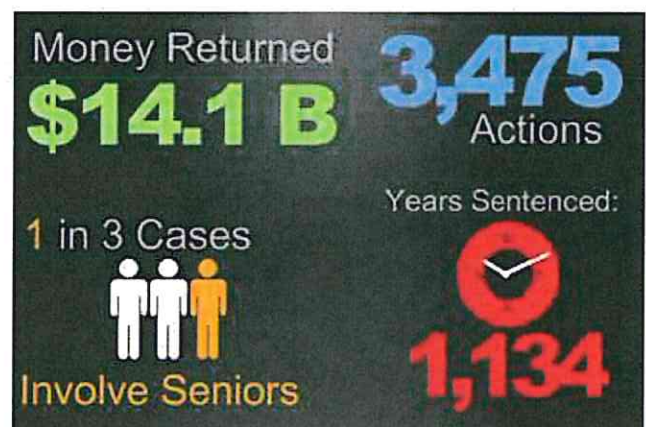
"State securities regulators stand ready to help the men and women who serve our country protect their hard-earned dollars," said Jack E. Herstein, NASAA President and Nebraska's securities regulator. "Unfortunately, military families may be targeted by con artists who exploit their ties to the military community to gain the trust of their victims."

Herstein urged military families to contact their state securities regulator to determine if the investment and the person recommending it are properly registered with the appropriate authorities.

NASAA's website features several resources designed to help military families learn how to avoid investment fraud, including the "Salute to Smart Investing" brochure and a series of financial conversation starters for military families.

## Enforcement by the Numbers

The NASAA Enforcement Section's annual survey of state securities regulators' enforcement activity showed a 51 percent increase in the number of enforcement actions by state securities regulators in 2010, which led to a nearly 200 percent increase in the amount of money ordered returned to investors. Of the more than 3,000 actions initiated by the states, a third involved the abuse of senior investors.



NASAA data from 2010

### NASAA Testimony

#### ***State regulators offer suggestions to cultivate innovative entrepreneurs without compromising investor protections***

*Continued from p. 1*

Both bills would, among other provisions, prevent state securities regulators from reviewing investment opportunities made on these websites before they are offered for sale to the public.

"Instead of preempting states, as both bills would do, Congress should allow the states to take a leading role in implementing an appropriate regulatory framework for crowdfunding," Herstein said.

Herstein told the committee that if regulatory authority is preserved for the states, NASAA will continue to pursue the development of a model exemption for crowdfunding that would allow "one-stop filing" in the state of the issuer's principal place of business.

"This streamlined approach can be achieved without preempting state securities regulators and is consistent

with the goals of both Congress and the Obama Administration to help small businesses access the capital they need in order to promote economic recovery and job growth," Herstein said.

He also suggested that Congress direct the SEC to work with the states to develop a federal exemption in tandem with a state model rule.

"Small business investment has the potential to be a very positive economic force and a major driver of wealth and jobs when done in the right way," Herstein said. "But when done incorrectly and without appropriate oversight, these investments have the potential to become costly failures. The challenge for Congress today is to balance the legitimate interests of investors with the legitimate goals of entrepreneurs."

### **States Form Committee to Study Small Business Capital Formation**

NASAA has formed a committee to examine and propose steps that state securities regulators can take to help small and new businesses raise investment capital.

The Small Business Capital Formation Committee is chaired by NASAA Vice President and Arkansas Securities Commissioner A. Heath Abshire.

"The committee's first priority will be to examine various initiatives to facilitate capital formation, including a possible model rule that state securities regulators may adopt to responsibly encourage small business capital formation through crowdfunding," NASAA President Jack E. Herstein said.

The committee's proposed model rule was circulated for internal comment in early 2012 and subsequently will be released for public comment.

The work of the new NASAA committee comes on the heels of several congressional measures to stimulate the economy and promote job creation.

In an October 21 letter, Herstein urged the House Financial Services Committee's leadership not to take a "rash and premature action" in the area of

crowdfunding.

"State securities administrators share the Committee's goal of promoting small business capital formation and job-growth, including exploring the establishment of a framework that might facilitate the harnessing of investment capital online through techniques like crowdfunding," Herstein wrote. "At the same time, NASAA believes it is vital that any such framework be crafted carefully and deliberately, as the potential for fraud in this area is real and potentially enormous."

"Preempting state authority is a very serious step and not something that should ever be undertaken lightly or without careful consideration, including a thorough examination of all available alternatives," Herstein said. "In the case of crowdfunding, state securities regulators are not only capable of acting, but indeed, are acting, and Congress should allow them the opportunity to continue to protect retail investors from the risks associated with smaller, speculative investments."

### 112th Congress

#### ***NASAA Agenda Balances Investor Protection and Economic Growth; Continues to Advocate Strong Implementation of Dodd-Frank Act***

NASAA's Legislative Agenda for the 112th Congress provides Congress with a blueprint of five core principles that will enable policymakers to demonstrate their continued commitment to investors.

Political pundits have been quick to point out the dysfunctional nature that characterized much of the first session of the 112th Congress. However, in the session's waning months, the approach of the 2012 election season and announcement by the President of a jobs plan in September helped crystallize congressional attention on a series of proposals advocating economic growth and job creation.

In various legislative proposals, NASAA's overarching policy position — the regulatory authority of state securities regulators — was challenged and demanded a strong defense. This challenge is likely to continue during the second session.

Still, progress was made on several of NASAA's legislative priorities during the first session of the 112th Congress.

#### ***1. Support Strong Implementation of the Dodd-Frank Act***

Dodd-Frank empowered state regulators by shifting mid-sized investment advisers from federal to state oversight. We continue to oppose any measures that would weaken the states' important role in protecting investors.

State securities regulators strongly supported inclusion of the Senior Investor Protection Program and continue working to see that the \$8 million annual authorization for these grants is distributed as intended.

#### ***2. Reserve Regulation for Regulators***

NASAA's agenda urges Congress to reject proposals to establish additional SROs and instead to provide federal and state regulators with the resources they need to effectively monitor the firms and representatives under their jurisdiction.

Legislation to create an SRO for investment advisers may emerge in the second session. NASAA believes investment adviser regulation should continue to be the responsibility of state and federal governments.

#### ***3. Strengthen Federal/State Collaboration***

NASAA believes that supporting an enhanced state/federal regulatory structure will build confidence in our capital markets. NASAA continues to advocate for policies that seek to enhance collaboration and enable the complementary system of state and federal securities regulation to continue to protect investors.

#### ***4. Impose a Fiduciary Duty on All Financial Professionals When Providing Investment Advice about Securities***

Applying the fiduciary standard to broker-dealers is necessary to protect investors from abuses fostered by current fragmented industry standards. The time has come to end this confusion and close the longstanding gaps in industry standards. The SEC must act without delay.

#### ***5. Provide Transparency, Enhance Protections and Reserve Choice of Forum for Investors***

Progress is being made in the area of forum choice. In accord with Dodd-Frank Section 921, the SEC is now studying mandatory arbitration agreements between investors and brokers. NASAA has long urged the SEC to prohibit mandatory pre-dispute securities arbitration and allow investors the choice between arbitration and litigation in an independent judicial forum.

Regarding transparency, NASAA supports the PCAOB Enforcement Transparency Act of 2011 (S. 1907) to amend the Sarbanes-Oxley Act to make the Public Company Accounting Oversight Board disciplinary proceedings open to the public.

Progress also is being made to enhance investor protection. NASAA supports the Senior Investor Protections Enhancement Act of 2011 (H.R. 774) and looks forward to similar legislation to be introduced in the Senate. The GAO also has completed its Dodd-Frank mandated study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws, and NASAA urges Congress to restore an effective private right of action under federal securities laws.

# New NASAA Initiative Helps Streamline the Switch

## IA Coordinated Review Program

NASAA has developed a coordinated review program for investment advisers switching from federal to state securities regulatory oversight as mandated by the Dodd-Frank Act.

"This program is designed to facilitate and streamline the review process for both the advisers and the states," said Jack E. Herstein, NASAA President and Assistant Director of the Nebraska Department of Banking and Finance Bureau of Securities.

Investment advisers with assets under management of between \$25 million and \$100 million are required to switch from federal to state registration by mid-2012.

"This initiative provides investment advisers registering in multiple states with an easier way to navigate the switch to state registration and gives states an opportunity to coordinate and resolve issues about potential problems with applicants," Herstein said.

The Investment Adviser Coordinated Review Program is open to SEC-registered investment advisers switching their registration to between four and 14 states.

Under Dodd-Frank, investment advisers registered in 15 or more states can remain with the SEC.

To participate in the program, eligible investment advisers must complete and submit the Coordinated Review Form found in the IA Switch Resource Center on the NASAA website at [www.nasaa.org](http://www.nasaa.org) in addition to filing all materials required by the states in which the adviser is applying for registration.

The states where the investment adviser has filed a registration application will conduct a coordinated review of the investment adviser's registration materials.

After completion of the review, the adviser will be informed of the deficiencies, if any, that must be resolved before the registration will be approved.

The program is available to investment advisers in all states except Wyoming and New York, where investment advisers will remain under the regulatory oversight of the SEC.

Herstein said there is no additional cost to use the program, which will conclude on March 30, 2012.

"Advisers will be subject only to the filing fees specified by the states in which the investment adviser is applying for registration," he said, noting that NASAA has waived IARD system fees for 2011 and 2012.

## IA Switch Calendar of Events

**April 26, 2012**

### IA Switch Seminar

Presented by the Michigan Securities Division  
Lansing, MI

**January 31, 2012**

### Investment Adviser Training Conference

Presented by the Massachusetts Securities Division  
Marlborough, MA

**January 23, 2012**

### IA Switch Presentation

Presented by the New Jersey Bureau of Securities  
Piscataway, NJ

**December 19, 2011**

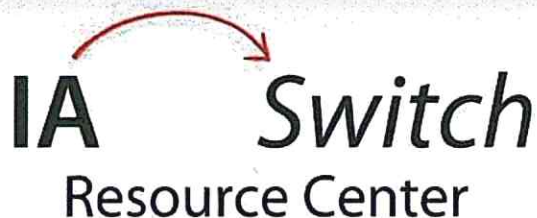
### IA Switch Seminar

Presented by the Colorado Division of Securities  
Denver, CO

**December 8, 2011**

### Oureach Seminar for Investment Advisers

Presented by the Maryland Division of Securities  
Ellicott City, MD



**IA Switch**  
Resource Center

Learn more at [www.nasaa.org](http://www.nasaa.org).

### ***NASAA Urges SEC and FINRA to Close Regulatory Gaps in Private Placements***

NASAA recently applauded FINRA for enhancing disclosure of private placement information to investors, but in a comment letter to the SEC also noted several ways to enhance investor protection both within the context of FINRA's proposed Rule 5123 and in future rulemakings by the SEC and FINRA.

"Despite the increased level of disclosure mandated by this proposal, investors in private placements will still be investing in securities that have not been substantively reviewed by any regulator. NASAA remains concerned about the regulatory gaps that exist in the current federal laws governing private placements," NASAA wrote.

While commending this initial step by FINRA, NASAA urged the SEC and FINRA to consider more substantive steps to increase investor protections with respect to private placements, including instituting a system for pre-offer and pre-sale review.

NASAA also expressed concerns that FINRA's proposal could potentially be read by member firms to exclude structured products as "credit and derivative" securities. FINRA and the SEC have both issued notices and studies regarding the extreme risks of investing in structured products and NASAA firmly believes that structured products should not be exempt from this proposal.

NASAA generally supports FINRA's efforts to increase the disclosure of information pertinent to the offer and sale of private placements. However, NASAA also continues to support a requirement that these securities be subject to substantive regulatory review.

### ***NASAA Membership Votes to Approve Exempt Reporting Adviser Model Rule***

The NASAA membership voted in December to approve the adoption of a model rule establishing an exemption from registration for investment advisers to certain private funds.

"This issue of how states may approach the registration requirements for private funds is of significant importance to states, private fund advisers and funds alike," said NASAA President Jack E. Herstein. "Providing a model rule will help promote uniformity and bring clarity to state regulation of private fund advisers."

Under the regulatory framework established by the Dodd-Frank Act, investment advisers to certain private funds that previously relied on an exemption from SEC registration will now be subject to registration.

Under the Act, investment advisers to certain private funds, including advisers to venture capital funds, will be exempt from registration but required to submit reports to the SEC.

States approach the regulation of advisers to private funds, including hedge funds, in different ways. In some states, these advisers are required to register while in others there are exemptions from registration.

To address the new regulatory treatment of these advisers, a team of NASAA members and staff drafted a model exemption from registration for this universe of investment advisers.

NASAA designed its model rule to follow certain provisions in the Dodd-Frank Act as implemented by the SEC.

### ***NASAA Amicus Supports Colorado Treatment of Joint Venture Interests as Securities***

NASAA recently filed an amicus brief with the Colorado Court of Appeals on behalf the Colorado Securities Commissioner in a case stemming from an appeal of a cease and desist order against a Texas oil and gas company for allegedly violating the securities registration and licensing provisions of the Colorado Securities Act in connection with the offer of securities in and from Colorado.

The Colorado Securities Board determined that the firm had offered a joint venture interest to Colorado investors. Although the joint venture was established by the firm as a general partnership under Texas law, the Board determined that the joint venture interests offered were securities under Colorado law. As a result, a cease and desist order was issued as the firm, its managing director and sales agent were found to be in violation of registration and licensing provisions of Colorado securities law. The firm appealed the order.

"Fraudulent schemes are increasingly being organized as general partnerships and joint ventures to avoid regulation and detection by state and federal securities regulators," NASAA's brief said. "Although fraud was not alleged in the instant case, a decision by this Court adopting a restrictive and inflexible approach to the definition of a security will provide a blueprint on how to evade regulatory scrutiny."

At issue is whether joint venture interests are "securities" under the Colorado Securities Act. NASAA argued that Colorado securities law jurisprudence relies on a fact-based, "economic realities" approach to the third prong of the Howey test to determine whether an issue can be classified as a security.

*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.



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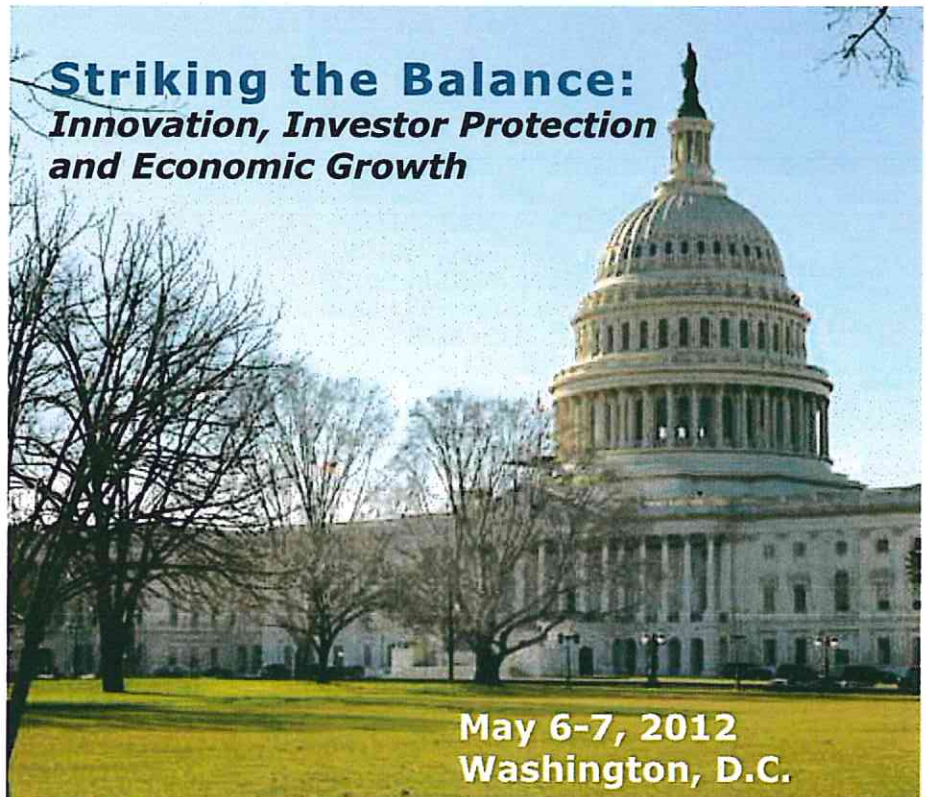
### **NASAA Public Policy Conference**

Washington Court Hotel  
Washington, DC  
May 7, 2012  
Register online at:  
[www.nasaa.org](http://www.nasaa.org)

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quarterly publication of the  
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## **NASAA Spring Conference**

**Striking the Balance:  
Innovation, Investor Protection  
and Economic Growth**



**May 6-7, 2012  
Washington, D.C.**