WRITTEN TESTIMONY OF JOSEPH P. BORG

PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

AND

DIRECTOR, ALABAMA SECURITIES COMMISSION

BEFORE THE

U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

"Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement"

June 13, 2018

WASHINGTON, DC

I. Introduction

Good Morning, Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee. I'm Joseph Borg, Director of the Alabama Securities Commission and President of the North American Securities Administrators Association ("NASAA").[1] It's been a privilege for me to serve as Director of the Alabama Securities Commission since 1994, and to have been elected as NASAA's President three times, most recently for a term spanning 2017-2018. I am honored to testify before the Subcommittee today about effectiveness, fairness, and transparency in the enforcement of federal and state securities laws.

In the United States, state securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator.[2] We are sometimes referred to as the "cops on the beat" as we are the securities regulators closest in proximity to your constituents. State securities regulators are responsible for administering state securities laws that both serve to protect your constituents from fraud while also providing regulatory frameworks through which businesses can raise capital. My colleagues and I are responsible for enforcing state securities laws including investigating complaints, examining broker-dealers and investment advisers, registering certain securities offerings, and providing investor education programs to your constituents. Ten of my colleagues are appointed by Secretaries of State, five serve in the state Attorney General's office or under the direction thereof, and others are appointed by their Governors and other senior state officials. Some, like me, work for independent commissions or boards. We are proud to work alongside our colleagues at the U.S. Securities and Exchange Commission ("SEC"), Commodities Futures Trading Commission ("CFTC"), and the Financial Industry Regulatory Authority ("FINRA") to police the securities markets and enforce our nation's securities laws.

States are leaders in civil and administrative enforcement actions, as well as criminal prosecutions of securities violators. Our most recently compiled enforcement statistics reflect that in 2016 alone, state securities regulators conducted nearly 4,300 investigations, leading to more than 2,000 enforcement actions, including 241 criminal actions. Moreover, in 2016, among licensed financial professionals, NASAA members reported 186 enforcement actions involving broker-dealer agents, 133 actions involving investment adviser representatives, 144 involving broker-dealer firms, and 157 involving investment adviser firms.

States also continue to serve a vital gatekeeper function by screening out bad actors before they have a chance to conduct business with unsuspecting investors. A total of 2,843 securities license applications were withdrawn in 2016 as a result of state action; and an additional 537 licenses were either denied, revoked, suspended or conditioned. State securities

[1] The oldest international organization devoted to investor protection, NASAA was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] Currently, 43 states have adopted a uniform securities act. The uniform securities acts were developed by the Uniform Law Commission for adoption by the states.

regulators continue to focus on protecting retail investors, especially those of your constituents who lack the expertise, experience, or resources to protect their own interests.

In addition to serving as "cops on the beat," state securities regulators serve as the primary regulators of many small and local securities offerings. As such, state securities regulators often work with and assist local businesses that seek capital investment. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the SEC, FINRA, and other regulators to effect greater uniformity in federal-state securities matters.

Finally, given the focus of today's hearing, it should be noted that state securities regulators are often first to discover and investigate our nation's largest frauds. In thinking about the role of state and federal enforcement authorities, it is instructive to look back at the regulatory responses to the major financial scandals over the past decade. From the investigation into the role of investment banks in the Enron fraud, to exposing securities analyst conflicts, "market timing" in mutual funds, and to uncovering problems in the auction rate securities market, state securities regulators have consistently been in the lead.

II. State Securities Regulators & Enforcement

The State Role in Securities Law Enforcement

Our capital markets function and grow in large part due to the trust investors place in market participants and the regulators. Maintaining that trust is essential to the continued primacy of our markets in an ever-competitive global marketplace. And integral to maintaining that trust is the work of state securities regulators in investigating suspected investment fraud, and, where warranted, pursuing enforcement actions. Keeping the bad actors out of the markets serves not only the interests of investors, but the businesses that rely on markets to raise capital.[3]

The enforcement role of state securities regulators differs in some ways from the SEC and self-regulatory organizations ("SROs") such as FINRA. Because our local offices are often the first to receive complaints from investors, state securities regulators serve as an early warning system, working on the front lines, investigating potentially fraudulent activity, and alerting the public to the latest scams.

States take aggressive enforcement actions against a wide variety of actors. From the fraudsters engaged in Ponzi or pyramid schemes to companies who mislead investors our

---

[3] For example, a report of the Group of 20 countries (G-20) issued in response to the financial crisis of 2008 concluded that "[n]o matter how sound the rules are for regulating the conduct of market participants, if the system of enforcement is ineffective – or is perceived to be ineffective – the ability of the system to achieve the desired outcome is undermined. It is thus essential that participants are appropriately monitored, that offenders are vigorously prosecuted and that adequate penalties are imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in the financial system." *See:* G-20 Working Group 1, *G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency – Final Report* (Mar. 25, 2009), accessible at http://www.gfintegrity.org/storage/gfip/documents/g20%20working%20group%201%20report.pdf.

message is simple – if you rip off or defraud investors we will take action. Whether acting independently or collaboratively, such as through the NASAA enforcement framework or in conjunction with our federal regulatory partners, state securities agencies have a long history of pursuing enforcement actions that affect not only the residents of our individual states, but also the citizens of our nation as a whole.

State securities agencies are less bureaucratic and usually nimbler than our federal counterparts. Upon identifying a problem, states can move quickly to halt ongoing investment frauds using a range of civil and administrative remedies.

For example, states led the charge in exposing conflicts of interest and disclosure failures in the market for auction rate securities. These efforts led to the return of billions of dollars to retail investors.[4] For example, in Alabama the repurchase of auction rate securities totaled $1.3 billion, saving Alabamians from defaulting on home loans, ruining their credit, and allowing them to pay their bills. States were similarly in the vanguard in exposing sell-side research analysts' conflicts of interest and abusive market timing practices by mutual fund investment advisers, which gave an unfair and illegal advantage to hedge funds and other large entities at the expense of retail investors. Working alongside the SEC, these matters resulted in significant settlements and, no less significantly, long-term changes in securities industry practices to prevent this conduct from recurring.[5]

In addition, state securities regulators recently have been acting at the intersections of law and technology. Last month, we announced preliminary results from "Operation Cryptosweep," a coordinated investigative effort of 40 NASAA members to target fraud and other securities law violations in the sale of initial coin offerings ("ICOs") and cryptocurrencies.[6] State securities regulators have already brought dozens of enforcement actions involving ICOs and other new and unique financial products. These actions are supportive of similar initiatives by federal regulators, and SEC Chairman Clayton applauded NASAA's efforts, saying they send a "strong warning to would-be fraudsters in this space that many sets of eyes are watching, and that regulators are coordinating on an international level to take strong actions to deter and stop fraud."[7]

---

[4] *See:* NASAA Auction Rate Securities Information Center, http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/auction-rate-securities-information-center/.

[5] *See:* Press Release No. 2003-54, U.S. Securities and Exchange Commission, *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (Apr. 28, 2003), accessible at https://www.sec.gov/news/press/2003-54.htm. *See also:* Press Release, North American Securities Administrators Association, *State, Federal Investigations Demonstrate 'Fundamental Unfairness' in Mutual Fund Industry* (Nov. 4, 2003), accessible at http://www.nasaa.org/7961/state-federal-investigations-demonstrate-%E2%80%98fundamental-unfairness%E2%80%99-in-mutual-fund-industry/.

[6] *See:* Press Release, North American Securities Administrators Association, *State and Provincial Securities Regulators Conduct Coordinated International Crypto Crackdown* (May 21, 2018), available at http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/.

[7] *See:* Public Statement of SEC Chairman Jay Clayton (May 22, 2018), available at https://www.sec.gov/news/public-statement/statement-nasaas-announcement-enforcement-sweep-targeting-fraudulent-icos-and.

In addition to investigating cases and bringing enforcement actions, states work with federal regulators on market-wide solutions when needed. Such collaborations have repeatedly demonstrated their value to investors and markets. In fact, it has been shown that in cases where state and federal regulators work cooperatively and leverage resources, the involvement of state securities regulators can produce significant increases in the penalty and restitution components of the federal regulator's enforcement efforts.[8]

Finally, although states do not engage in rulemaking for the national markets – that is the purview of the SEC and the SROs under federal law – state regulators are active participants in the SEC's rulemaking process and work to align federal and state securities regulations.

Securities Enforcement Coordination: Federal and State

State and federal securities regulators collaborate on a voluntary basis, usually at the regional level, with common goals of sharing information and leveraging resources efficiently. Collaboration includes ongoing informal quarterly or monthly meetings at the state or regional levels; regulators working on investigations and enforcement cases when the nature of the case warrants collaboration; and other initiatives, such as memorandums of understanding ("MOUs").

Recently, to facilitate federal-state coordination, NASAA entered into important information sharing MOUs with federal regulators. In 2017, the SEC and NASAA signed an MOU to facilitate sharing information about intrastate crowdfunding offerings and regional securities offerings. This should help small businesses raise needed capital. More recently, in May 2018, NASAA signed an MOU with the CFTC to foster a closer working relationship between the CFTC and state securities agencies.[9] This MOU will facilitate information sharing about violations of the Commodity Exchange Act. In recent Congressional testimony, CFTC Chairman Christopher Giancarlo described the MOU as "marking a milestone in the area of U.S. federal and state financial fraud detection and prosecution."[10]

Securities Enforcement Coordination: State to State

NASAA serves as a forum to facilitate collaboration among its members in multijurisdictional enforcement matters. State regulators who are members of NASAA's Enforcement Section routinely assist in coordinating these cases by sharing information and leveraging state resources in the most efficient way.[11] Each year the section compiles data from

---

[8] *See:* Eric Zitzewitz, *An Eliot Effect? Prosecutorial Discretion in Mutual Fund Settlement Negotiations*, 2003-7, accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1091035.

[9] *See:* Press Release, North American Securities Administrators Association, *CFTC, NASAA Sign Agreement for Greater Information Sharing Between Federal Commodities and State Securities Regulators* (May 21, 2018), accessible at http://www.nasaa.org/45123/cftc-nasaa-sign-agreement-for-greater-information-sharing-between-federal-commodities-and-state-securities-regulators/.

[10] *See:* Testimony of CFTC Chairman J. Christopher Giancarlo Before the Senate Committee on Appropriations Subcommittee on Financial Services and Government Affairs, p.9. (Jun. 5, 2018), accessible at https://www.appropriations.senate.gov/imo/media/doc/060518%20-%20CFTC%20Giancarlo%20Testimony.pdf.

[11] There are numerous examples of collaboration among state securities regulators in multijurisdictional enforcement matters. *See: e.g.,* Press Release, North American Securities Administrators Association*, State*

participating NASAA jurisdictions and publishes this information in an annual enforcement report.

III. NASAA's Perspective on H.R. 5037 and H.R. 2128

The Committee has requested NASAA's views on the two bills pending before the Committee, H.R. 5037 and H.R. 2128. I will discuss each in turn.

H.R. 5037: "The Securities Fraud Act of 2018"

If enacted, H.R. 5037 will harm the investors that state regulators are charged with protecting by preempting state securities regulators' civil enforcement authority and by impeding – if not outright preempting – state criminal securities fraud prosecutions. The bill should be understood as nothing less than an attempt to tie the hands of state regulators, the "cops on the beat" closest to Main Street investors, in favor of large companies engaged in or suspected of securities fraud. H.R. 5037 represents a dramatic encroachment by the federal government on state police powers and is bad for investors and bad for our capital markets.

As a threshold matter, the putative findings in Section 2 of the bill are inaccurate. State securities regulatory authority was entirely unrestricted for most of the 20th century, until passage of the National Securities Market Improvement Act of 1996.[12] In 1996 Congress realigned state and federal regulatory authority over the offer and sale of nationally traded securities and of the broker-dealer and investment advisory industries. What Congress did not do was preempt any aspect of state antifraud authority. In fact, Congress deliberately left this authority fully intact.[13] In a colloquy on the floor of the House, Representatives Moran and Bliley discussed this precise point:

Congressman Moran:	"Mr. Speaker, . . . our State Corporation Commission in Virginia . . . [is afraid] they will not have sufficient enforcement authority [after NSMIA] . . . ."

Securities Regulators File Action Against Morgan Keegan (Apr. 7, 2010), accessible at http://www.asc.state.al.us/News/2010%20News/4-7-10%20Morgan%20Keegan%20show%20cause.pdf; Press Release, North American Securities Administrators Association, *State Securities Regulators Announce $26 Million Settlement with LPL Financial LLC Involving Sales of Unregistered, Non-Exempt Securities* (May 2, 2018), accessible at http://www.nasaa.org/44990/state-securities-regulators-announce-26-million-settlement-with-lpl-financial-llc-involving-sales-of-unregistered-non-exempt-securities/; Press Release, North American Securities Administrators Association, *State Securities Regulators Announce Settlement with Bankers Life and Casualty Company* (Apr. 4, 2012), accessible at http://www.nasaa.org/11996/state-securities-regulators-announce-settlement-with-bankers-life-and-casualty-company/. *See also: e.g.,* In the Matter of Prudential Securities, Inc., 51 SEC 726 (1993); SEC v. Prudential Securities Inc., No. 93-2164 (EGS) (D.D.C. Jan. 21, 1993); and SEC v. Prudential Securities Inc., 171 F.R.D. 1, 2 (D.D.C. 1997), *aff'd*, 136 F.3d 153 (D.C. Cir. 1998).

[12] Pub. Law 104-290, 110 Stat. 3416 (1996).

[13] "The Managers have preserved the authority of the states to protect investors through application of state antifraud laws." *See:* H.R. Rep. No. 104-864, 1996 WL 559878 (1996).

Congressman Bliley:	"Mr. Speaker, reclaiming my time, they have all of that enforcement authority and they retain their fees."
Congressman Moran:	"They retain their fees and enforcement authority."
Congressman Bliley:	"That is correct."[14]

This was not the first time Congress did so. In 1995, when Congress was considering the Securities Litigation Uniform Standards Act of 1998, it included a *statutory* preservation of state antifraud authority.[15] Another example of Congress's recognition of the importance of state antifraud authority came in the form of the rejection in 2003 of an amendment to the Securities Fraud Deterrence and Investor Restitution Act that would have placed limits on state antifraud authority.[16] The state-federal balance struck by Congress in the regulation and enforcement of securities laws has been debated and settled. The attempt to upend this balance in H.R. 5037 in favor of firms and individuals suspected of securities fraud should be rejected yet again.

Furthermore, H.R. 5037 is premised on the specious assertion that state securities enforcement is detrimental to the public interest and somehow disincentivizes capital raising. Such a premise is unsupported by either logic or fact.[17] As the U.S. Treasury Department recently reported, America's capital markets are "the largest, deepest, and most vibrant in the world," and U.S. businesses "successfully derive a larger portion of business financing from [America's] capital markets, rather than the banking system, than most other advanced economies."[18] The Financial Services Committee has, for the past five-and-a-half years, conducted rigorous oversight of the U.S. capital markets holding at least twenty hearings with dozens of witnesses and as a result passed numerous measures designed to facilitate capital formation. All of these bills have left untouched state antifraud authority in recognition of the

---

[14] 142 Cong. Rec. H6436-05, 1996 WL 332161 (1996).

[15] 15 U.S.C. §77p(e).

[16] *See:* Cheryl Nichols, *H.R. 2179, The Securities Fraud Deterrence and Investor Restitution Act of 2004: A Testament to Selective Federal Preemption*, 31 Suffolk Transnat'l L. Rev. 533 (2008).

[17] A recent analysis, by EY, of trends in the U.S. capital markets identified the following four factors as the basis for a challenging IPO climate: (1.) economic or geopolitical uncertainty; (2.) market declines; (3.) a risk averse investor mindset; and (4.) poor recent IPO performance. Notably absent from this list of factors is state enforcement activity. *See:* EY, *Looking Behind the Declining Number of Public Companies – An Analysis of Trends in US Capital Markets* (May 2017), available at https://www.ey.com/Publication/vwLUAssets/an-analysis-of-trends-in-the-us-capital-markets/$FILE/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf. Furthermore, an exhaustive list of recommendations by the U.S. Department of the Treasury to bolster the capital markets does not include a recommendation to weaken state enforcement authority. *See:* U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities - Capital Markets* (Oct. 2, 2017), available at http://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf. Finally, a recent report by a coalition of organizations including the U.S. Chamber of Congress Center for Capital Markets Competitiveness explored a number of recommendations to address the decline in the number of public companies, none of which advocate for the preemption of state enforcement authority. See: U.S. Chamber of Commerce, *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public* (Apr. 26, 2018), accessible at https://www.uschamber.com/sites/default/files/ipo_report_expanding_the_on-ramp.pdf.

[18] *Ibid.*

important role this authority plays in maintaining confidence in U.S. markets.[19] In short, the evidence simply does not support the assertion that state enforcement is detrimental to capital formation.

More tangibly, though, H.R. 5037 is problematic because of the negative impact it would have on the ability of states to protect investors and punish those who commit securities fraud.

Analysis of H.R. 5037

First, H.R. 5037 would preempt state civil antifraud authority for certain violations of state securities laws, putting Main Street investors at risk.

H.R. 5037 would amend the Securities Exchange Act by adding new state law preemption provisions whereby states would be prohibited from pursuing certain civil securities fraud cases. The relevant provisions are drafted in such a way that they are ambiguous as to scope. At a minimum, states would be prohibited from pursuing civil fraud cases against the issuers of publicly traded securities. However, the preemption provisions are drafted such that a defendant could argue and a court could find that states are preempted from pursuing civil fraud violations in connection with any transaction involving publicly traded securities. Under such an interpretation, for example, the bill would preempt state enforcement actions against a broker-dealer and/or its associated person(s) for defrauding customers so long as the fraud involved a covered security. I have had enough experience trying securities fraud cases that I know defendants will make the argument that the ambiguous preemption provisions should be construed broadly in order to shield their violative conduct from state enforcement action.

Second, H.R. 5037 would hamper or prevent state prosecutions of criminal securities fraud.

Section 3(a) of H.R. 5037 would amend the Securities Exchange Act to add new Section 21G(c)(2), which would require that state criminal securities fraud prosecutions "comply in all respects" with federal legal requirements. This provision is also inherently ambiguous and poorly drafted and as a result has the potential to be extremely problematic for all state criminal authorities.[20] Depending on how the provision is interpreted by the courts, it could hamper – if not outright preempt – state criminal securities fraud prosecutions. (For example, I am aware of no state judge or judiciary panel in Alabama that will agree to suspend all state criminal laws and procedures in favor of federal requirements.)

H.R. 5037 does not provide any direction or clarification regarding how states could satisfy the requirements of Section 21G(c)(2) or what it means to "comply in all respects" with

---

[19] In addition to various hearings held pursuant to its mandate to oversee the Securities and Exchange Commission, the House Financial Services Committee and its Subcommittee on Capital Markets have held at least twenty hearings intended to examine capital formation in the U.S. equity markets under Chairman Hensarling. This includes at least eight hearings in the 113th Congress, seven in the 114th Congress, and six in the current 115th Congress, to date.

[20] The adverse effect of this provision would apply to district, county and all other non-federal prosecutions.

federal law.[21] Defendants in state criminal prosecutions would of course vigorously advocate for the broadest possible reading of this language. Thus, for practical purposes, Section 21G(c)(2) will be preemptive in its effect to the extent that no state judge or judiciary panel will agree to suspend all state criminal law and procedure. In essence, Section 21G(c)(2) functions as a directive to state prosecutors and courts that state criminal cases must be referred to federal prosecutors, to be tried in federal courts.

At a minimum, by forcing state regulators, state courts, and state prosecutors to comply with federal legal requirements applicable to securities fraud cases, Section 3(a) would have a chilling effect on the willingness and ability of states to bring criminal securities fraud prosecutions if not halt all such actions altogether.

I imagine that the fraudsters, including the ones my office has prosecuted, would be pleased with such a result.

Third, H.R. 5037 will deprive defrauded investors of a choice in forum in seeking recourse for their claims.

Section 3(a) of H.R. 5037 would amend the Securities Exchange Act by adding Section 21G(b), which states that all civil (*i.e.*, private) securities fraud claims involving covered securities shall proceed in federal district courts under federal law. There are no exceptions. This would prevent all private litigants from seeking relief in state court for securities fraud claims arising in connection with covered securities (to the extent such claims are not already foreclosed by the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA")). Under the bill, defrauded investors pursuing private securities fraud claims outside of the class action context would no longer have a choice of forum in which to pursue their claims. Section 3(a) thus represents a direct threat to state pension funds that would require them to litigate in federal courts, and other investors who seek to "opt-out" of shareholder class action litigation and instead advocate on their own behalf in pursuing claims against an issuer.

Views Regarding H.R. 5037

Based on the significant harm H.R. 5037 poses for investors NASAA opposes this legislation in the strongest possible terms. Enacting policies that would make it more difficult, and in some cases impossible, for state regulators – the regulators closest to Main Street investors – to hold accountable the most powerful companies on Wall Street serves no valid interest. State antifraud provisions serve as a deterrent to improper conduct by companies and the potential consequences of violating these laws serves as an incentive to these companies to provide investors with complete and accurate information.[22] Moreover, while state regulators are judicious in exercising their enforcement authority against publicly traded companies, states' authority to pursue enforcement activity against issuers of securities, and to do so independently

[21] For example, it is an open question under H.R. 5037 whether litigation in state courts would have to apply federal rules of civil or criminal procedure and federal rules of evidence.

[22] State antifraud provisions can both raise the amount of any potential penalty and, even more importantly, raise the probability of detection and prosecution of those companies that commit securities fraud.

when appropriate, is a major deterrent to fraud and one of many reasons investors have confidence in America's capital markets.[23]

Beyond the overarching backwardness of the policies prescribed by H.R. 5037, the enactment of which would be inadvisable at any juncture, NASAA questions the basis for Congress's interest in curtailing state enforcement authorities at the present time. Indeed, given the recent and marked decline in enforcement actions by the SEC against public companies, this would appear to be the most inopportune time for Congress to tie the hands of states in policing fraud by publicly traded companies.[24] The proposed legislation would also shift policies in a direction diametrically opposed to those encouraged by the current Administration, which favors states' rights, and encourages the exercise of state authority with regard to enforcement activity.[25]

In sum, H.R. 5037 is a misguided and dangerous bill. It is premised on a flawed understanding of the importance of state securities enforcement functions in protecting "mom and pop" investors and deterring fraudulent conduct in our securities markets. In every instance, the bill places the interests of big companies above those of the hardworking Americans who look to our capital markets to help build a secure retirement. For all the foregoing reasons, NASAA opposes the bill, and strongly encourages the Committee to reject it.

H.R. 2128: "The Due Process Restoration Act of 2018"

The Due Process Restoration Act seeks to benefit respondents in SEC enforcement actions by providing them with a broad right of removal to federal district courts. The bill also would raise the burden of proof in SEC administrative proceedings from preponderance of the evidence to clear and convincing evidence. While we understand that there are due process concerns evidently underlying the bill, the bill would have deleterious downstream consequences for the public interest and, ultimately, for respondents in SEC enforcement actions. The bill would likely cause most SEC enforcement actions to proceed in federal district courts, burdening the courts and limiting the opportunities for administrative resolution of SEC actions.

---

[23] According to legal research on the role of enforcement in promoting market integrity, a "growing body of academic research has found that foreign corporations that do cross-list on a U.S. exchange seem to reap extraordinary benefits," including "a valuation premium compared to otherwise similar firms that do not cross-list in the United States, which at least one study has found to average 37% for foreign firms cross-listing on a major U.S. exchange." *See:* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 235 (2007).

[24] According to an analysis published by New York University's Pollack Center, new SEC enforcement actions against public companies decreased by 33% from FY 2016 to FY 2017. Likewise, SEC settlements declined by more than 80% over 2017, from $1 billion in the first half of FY 2017 to $196 million in the second half, and penalties during the second half of FY 2017 accounted for only 16% of total settlements for the fiscal year – the lowest percentage and dollar amount for any half year since FY 2010. *See:* Cornerstone Research, *SEC Enforcement Activity: Public Companies and Subsidiaries – Fiscal Year 2017 Update* (2017), available at http://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-2017-Update.

[25] *See:* Office of Management and Budget Director and Consumer Financial Protection Bureau Acting Director Mick Mulvaney remarks to the National Association of Attorneys General winter meeting, "We're going to be looking to the state regulators and the states' attorneys general for a lot more leadership when it comes to enforcement" (Feb. 20, 2018), available at https://www.c-span.org/video/?441853-4/consumer-financial-protection-bureau-acting-director-mick-mulvaney.

Analysis of H.R 2128

Sections 40(a) and 40(b) of the bill would give respondents in SEC administrative enforcement actions where penalties could be imposed the right to remove the action to federal district court. More importantly, Section 40(c) would raise the burden of proof in administrative proceedings from a "preponderance of the evidence standard" to a "clear and convincing standard." This would incentivize respondents not to remove the action to federal court – and also disincline the SEC to ever bring enforcement actions administratively in the first place.

Views Regarding H.R. 2128

NASAA sees no good reason for Congress to enact the changes contemplated by H.R. 2128 – and several reasons why these changes would disrupt our securities markets and the efficient functioning of the federal judiciary.

First, the SEC has broad statutory authority to seek penalties administratively.[26] Given this, the removal power conferred by H.R. 2128 would allow respondents – all respondents, including SEC-registered broker-dealers, investment advisers and their respective registered and associated persons – to remove nearly all SEC administrative actions to federal court. Administrative proceedings generally proceed faster than federal court cases and affording respondents a right of removal would invariably slow the SEC enforcement process, delaying justice. It would also add to the caseload of our already overburdened federal judiciary.

Further, the downsides of Sections 40(a) and 40(b) pale in comparison to the potential negative consequences of Section 40(c). Section 40(c) represents a potential death knell for SEC administrative practice. By raising the standard of proof in SEC administrative proceedings to clear and convincing evidence, the bill would disincline the SEC from bringing any cases administratively. This would slow justice and clog the courts and, when taken with the other sections of the bill, give respondents an opportunity for regulatory arbitrage. If the SEC brought an action administratively, the respondent could choose to proceed in that forum or remove the case to federal district court (and proceed under a lesser preponderance of the evidence burden of proof). H.R. 2128 thus represents a significant change in SEC enforcement jurisprudence and likely would substantially increase the number of SEC enforcement cases filed in federal court.

NASAA urges the Committee to reject this legislation.

IV. NASAA's Views on Certain Federal Securities Enforcement Matters

SEC Regulation D, Rule 506 and the Private Placement Market

Private securities once comprised just a fraction of the overall marketplace, but today they serve as a major source of investment capital for certain businesses, exceeding public

---

[26] *See*: *e.g.*, Section 21B of the Securities Exchange Act of 1934.

markets.[27] Unfortunately, these markets are inherently inefficient and risky. Because private placement offerings are exempt from registration at both the state and federal levels, no state or federal regulator reviews these offerings before they are sold to investors.[28] It should not be surprising that these offerings routinely rank among the most common products or schemes leading to enforcement actions in surveys of state securities regulators.[29]

Securities sold in compliance with Regulation D, Rule 506 are "covered securities," which results in preemption of state-level registration requirements. However, the states retain antifraud jurisdiction and, for all practical purposes, are responsible for policing this market, only after the losses have been inflicted on America's Main Street investors. As the regulators closest to hardworking Americans, state securities regulators frequently receive complaints from those who are victimized in offerings conducted under Rule 506, and private placements are commonly listed on NASAA's annual list of top investor traps. As a result, the states have a very large stake in the SEC's rulemaking in this area, as well as in any legislative changes that would affect the private securities market.

NASAA is not wholly opposed to efforts to modernize the accredited investor standard, including in a manner that would increase the size of this marketplace. However, if Congress or the SEC wish to grow these markets, that should occur only in tandem with reforms that provide regulators with the tools necessary to address fraud and misconduct and improve transparency in this growing segment of the U.S. markets. NASAA believes that modest changes can be made to Rule 506 and Form D that will enhance the ability of the Commission and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital.[30] We have also offered suggestions to the SEC and Congress as to how to revise the current accredited investor definition such that it more accurately measures investor sophistication and at the same time improves regulatory oversight of this important segment of our markets.[31] In the absence of such concrete improvements in the oversight of these offerings,

---

[27] *See:* SEC Division of Economic and Risk Analysis, *Access to Capital and Market Liquidity* (Aug. 8, 2017), available at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf. *See also:* Scott W. Bauguess, Deputy Director, SEC Division of Economic Risk and Analysis, *Private Securities Offerings post-JOBS Act*. Presentation to Accounting Standards Executive Committee (Feb. 25, 2016), available at https://www.sec.gov/info/smallbus/acsec/private-securities-offerings-post-jobs-act-bauguess-022516.pdf.

[28] As described in SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), the Commission conducts no substantive review of Form D filings to determine whether an issuer actually complies with Rule 506. Accessible at http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf.

[29] *See:* NASAA Enforcement Report – 2015 Report on 2014 Data, p.7 (Sep. 2015), available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf.

[30] NASAA has repeatedly expressed support for amendments the SEC proposed in July 2013 that would make modest changes to Rule 506 and Form D that will significantly enhance the ability of the SEC and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital. *See:* http://www.nasaa.org/wpcontent/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf.

[31] The current income and net worth standards were established by the SEC in 1982 and have not been adjusted to reflect the impact of inflation. Had the thresholds been adjusted for inflation when they were put in place by the SEC in 1982, the income threshold today would be approximately $500,000 and the net worth threshold would be approximately $2.5 million. However, if Congress wishes to maintain the current income and net worth standards, other investor protection tools, such as investment limits, could be put into place to account for the effects of not adjusting the standards for 35 years.

NASAA remains opposed to legislation that would further expand the size of the marketplace for private securities by increasing the number of persons who qualify as "accredited investors."

Finally, as the Subcommittee is undoubtedly aware, the unprecedented expansion of the private placement market in recent years is a primary driver of the decline in initial public offerings ("IPOs") during the same period. There are a variety of factors contributing to the decline in IPOs. Some examples would include expanded use of Regulation D, Rule 506, business development companies, venture capital and private equity funds, and the federal crowdfunding laws. The simple fact is that it is easier now to raise capital through private securities offerings than at any other time in our history.[32] Given Congress's ongoing, bipartisan interest in taking steps to increase the number of IPOs – efforts which have recently been the focus of hearings by the Subcommittee – Congress should be very cautious about taking any steps that would further expand the private markets at the expense of public markets.

SEC Penalty Authority

When it comes to protecting investors from bad actors, aggressive enforcement actions that penalize violators, disgorge ill-gotten gains, and provide damages and restitution for aggrieved investors, are the best deterrent and the only proven remedy. In order for enforcement to be effective as a deterrent, the costs to violators must be meaningful as a punishment. Hearings in the wake of the financial crisis established that the present statutory limit on the SEC's authority to pursue civil penalties significantly ties the hands of the SEC in performing its enforcement duties.[33]

Federal securities laws currently limit the amount of civil penalties that the SEC can impose on an institution or individual. Specifically, under existing law, the SEC can only penalize individual violators a maximum of $150,000 per offense, and institutions $725,000 per offense.[34]

---

[32] As Healthy Markets Association Executive Director, Tyler Gellasch, noted in his testimony to this Subcommittee last month, "It's not a great mystery why in the last few years the trend has developed whereby there are more private offerings in the U.S. today than public ones. In the past, the law and SEC rules simply didn't permit all these private offerings. Over the past two decades, however, Congress and the SEC have spent years constructing ad hoc exemptions and exceptions designed to allow firms, their executives, and their early investors to sell securities without incurring the costs or burdens typically associated with public offerings. While some of these exemptions and exceptions may have been well-intended, the undeniable result has been that they have grown so dramatically that they have undermined the public markets." *See:* Testimony of Tyler Gellasch before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment (May 23, 2018), accessible at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-tgellasch-20180523.pdf.

[33] *See:* Senate Committee on Banking, Subcommittee on Securities, Insurance and Investment. Hearing entitled "Strengthening the S.E.C.'s Vital Enforcement Responsibilities." May 7, 2009.

[34] In some cases, the SEC may calculate penalties to equal the gross amount of ill-gotten gain, but only if the matter goes to federal court, not when the SEC handles a case administratively.

NASAA supports legislation that has been proposed in Congress that would increase the per violation cap applicable to the most serious securities laws violations.[35] NASAA also supports proposals to provide the SEC with the discretion to increase the amount of the penalty in cases where the size of the penalty is tied to the amount of money gained by the bad action.[36]

SEC Enforcement Resources

The SEC's Division of Enforcement polices approximately 8,000 public companies and more than 26,000 registered market participants. While highly skilled and dedicated to their mission, the fact remains that the SEC Enforcement Staff of approximately 1,400 is less than 4 percent of the number of companies the SEC oversees, and easily less than 0.1 percent of the employees of those companies. As Ranking Member Maloney noted at a recent hearing of the Subcommittee on Capital Markets, Securities, and Investment, "given this huge disparity, there's simply no way that the enforcement division can catch and punish every single violation of the securities laws."[37]

Earlier this year the SEC announced a $1.658 billion budget request for fiscal year 2019 to support its "core mission" and expand "oversight and enforcement in emerging areas such as financial innovation, market structure and cybersecurity." Of note, this would reflect a modest increase in funding and allow the SEC to lift a hiring freeze that has been in place for several years.[38] NASAA strongly urges Congress to fully fund the SEC's fiscal year 2019 budget request.

SEC Disgorgement Authority (*Kokesh v. SEC*)

The American people need Congress to enact legislation granting the SEC statutory authority to bring federal court claims for disgorgement and restitution. The SEC has authority to seek disgorgement through its own administrative courts.[39] But the SEC lacks explicit authority to do so in federal court. Traditionally this has not been a problem, and the SEC has for decades relied on federal courts' own inherent equitable powers to obtain disgorgement from wrongdoers.[40] The SEC often returns these monies to harmed investors. But the necessity for Congress to enshrine the SEC's disgorgement and restitution authority in federal law has been brought to the fore by the Supreme Court's decision last year in *Kokesh v. SEC*.[41]

---

[35] For example, S.779 – The Stronger Enforcement of Civil Penalties Act of 2017. (Similar provisions are also included in H.R. 10, the Financial CHOICE Act of 2017.)

[36] *Ibid*.

[37] *See:* U.S. House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investments. Hearing entitled "Oversight of the SEC's Division of Enforcement." (May 16, 2018).

[38] *See:* Testimony by Chairman Jay Clayton Before the Senate Committee on Appropriations Subcommittee on Financial Services and Government Affairs. (Jun. 5, 2018). Accessible at https://www.sec.gov/news/testimony/testimony-financial-services-and-general-government-subcommittee-senate-committee.

[39] *See:* Section 21C(e) of the Securities Exchange Act, 15 U.S.C. § 78u-3(e).

[40] *See:* SEC v. Texas Gulf Sulphur, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part* 446 F.2d 1301 (2d Cir. 1971).

[41] Kokesh v. SEC, 137 S. Ct. 1635 (2017).

In *Kokesh*, the Supreme Court reversed decades of established jurisprudence by holding that SEC disgorgement is a "penalty" subject to the five-year statute of limitations in 28 U.S.C. § 2462. The Court furthermore in a footnote questioned the SEC's ability even to obtain disgorgement in federal court.[42] *Kokesh* followed on the heels of another problematic Supreme Court decision, *Gabelli v. SEC.*[43] In *Gabelli*, the Court held the SEC cannot benefit from the so-called "discovery rule" to toll the beginning of the statute of limitations period when it seeks penalties. The Supreme Court no doubt thought it was doing what federal law commanded when it issued the *Kokesh* and *Gabelli* decisions. But these two decisions have only negative implications for the American people.

Kokesh and *Gabelli* will severely limit the SEC's ability to recover from wrongdoers in the future. Fraudsters will use these decisions to avoid returning ill-gotten gains to harmed investors. Imagine the American people's outrage if a future Ponzi schemer is able to retain the proceeds from his fraud simply because he evaded detection long enough. (The American people are fortunate that *Kokesh* and *Gabelli* were not the law of the land when the Bernie Madoff and Allen Stanford schemes finally came to light.)

The SEC is stuck with *Kokesh* and *Gabelli* and the agency is adjusting its enforcement activities in response. But the American public should not have to be stuck with these bad decisions. Congress can – and should – legislatively override these rulings by revising the federal securities laws to make clear that the SEC has authority to seek disgorgement and restitution in federal court and that no statute of limitations applies to these remedies. In Alabama, we took such a step in 2014 when we revised our state laws to provide prosecutors in Alabama (such as myself) the ability to pursue felony securities fraud or theft by deception charges for five years from our *discovery* of the fraud.[44]

V. CONCLUSION

I will close my testimony by reiterating my opposition to H.R. 5037. In more than 24 years as a securities regulator, I don't believe that I've ever seen a legislative proposal that so alarms me, offends me, and worries me. Should Congress pass this bill, my office's efforts, as well as those of my colleagues, to protect investors from serious violations of the securities laws would be eviscerated. Real investors in your districts – you can call them "Mom and Pop" investors, call them "Mr. and Mrs. 401K" – but real investors, and real people, will suffer as a result of this misguided and irresponsible legislation.

Thank you, Mr. Chairman and Ranking Member Maloney, for the opportunity to appear before the subcommittee today. I will be pleased to answer any questions you may have.

---

[42] *Id.* n.3.

[43] Gabelli v. SEC, 133 S. Ct. 1216 (2013).

[44] *See:* Press Release, Alabama Securities Commission, *Alabama Statute of Limitations Bill Signed by Governor Bentley* (Apr. 9, 2014), http://asc.alabama.gov/News/2014%20News/4-9-14%20HB325%20Signed%20and%20now%20law%20FNL.pdf.