

**WRITTEN STATEMENT OF MIKE ROTHMAN  
PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS  
ASSOCIATION, INC.**

**AND**

**MINNESOTA COMMISSIONER OF COMMERCE**

**BEFORE THE**

**U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES**

**“A Legislative Proposal to Create Hope and Opportunity for Investors,  
Consumers, and Entrepreneurs”**

**April 26, 2017**

**WASHINGTON, DC**

## **I. Introduction**

Good morning Chairman Hensarling, Ranking Member Waters, and Members of the Committee. On behalf of the North American Securities Administrators Association, Inc. (“NASAA”), I am pleased to submit this statement for inclusion in the record of the April 26, 2017, hearing entitled “A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs,” which will examine recently released “discussion draft” legislation entitled “The Financial CHOICE Act of 2017” (“Financial Choice Act” or “bill”).

NASAA was organized in 1919, and 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. In the United States, state securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. 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.

State securities regulators enforce state securities laws by investigating suspected investment fraud, and, where warranted, pursuing enforcement actions that may result in fines, restitution to investors and, in some instances, jail time. Keeping the bad actors out of the markets serves not only the interests of investors, but the businesses that rely on markets to raise money. State securities regulators also ensure honest financial markets by licensing registrants—both firms and investment professionals—and conducting ongoing compliance inspections and examinations.

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 regularly provide important information to local businesses seeking investment capital. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the U.S. Securities and Exchange Commission (“SEC” or “Commission”) to effect greater uniformity in federal-state securities matters.

Finally, both independently and within the framework of NASAA, state securities regulators have consistently provided Congress and other federal policymakers with timely, pertinent information, gleaned from our experiences, which may be relevant to federal policymaking activities. During the approximately two years between the onset of the Financial Crisis in August 2008, and the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) in July 2010, NASAA provided extensive commentary to Congress on financial regulatory reform legislation, including through testimony and more than a dozen letters addressing legislative proposals under the jurisdiction of the Financial Services Committee. Further, in January 2010, NASAA delivered detailed testimony to the U.S. Financial Crisis Inquiry Commission regarding the perspective of state securities regulators on the Crisis, and since 2011, NASAA’s membership and staff have actively participated in the activities of the Financial Stability Oversight Council (“FSOC”), as well as several federal advisory committees and similar working groups.

## **II. NASAA’s Perspective on the Financial Choice Act of 2017**

Congress enacted the Dodd-Frank Act in July 2010, in response to the financial crisis of 2008-2009, to strengthen our financial system and better protect the millions of hard-working Americans who rely on their investments for a secure retirement. The Dodd-Frank Act was crafted to promote stronger investor protection and provide more effective oversight to help prevent another economic crisis. Passage of the Act was central to the restoration of the confidence of Main Street investors in our capital markets. In addition to provisions designed to strengthen our financial system, the Dodd-Frank Act addressed a

number of critical issues affecting retail investors, such as incorporating disqualification provisions to prevent securities law violators from conducting securities offerings under SEC Regulation D, Rule 506; strengthening the accredited investor standard; increasing state regulatory oversight of investment advisers; providing for a means to enact a fiduciary duty for broker-dealers; providing authority to prohibit or limit the use of mandatory pre-dispute arbitration contracts by broker-dealers in customer agreements, among many other important reforms.

The reforms and investor protection provisions in the Dodd-Frank Act were born of necessity: trust in the market needed to be restored if our system of capital formation was to thrive. The financial crisis had underscored that the existing securities regulatory landscape required an overhaul. By passing the Dodd-Frank legislation into law, Congress signaled the beginning of a new era of financial market oversight and investor protection, including reforms intended to better empower state securities regulators to protect citizens from fraud and abuse.

As is true of any major legislation, the Dodd-Frank Act requires improvements and updates; however, the Financial Choice Act does not improve nor build upon the modernized financial regulatory framework that Congress crafted in response to the lessons of and weaknesses exposed by the Financial Crisis. Rather, the bill is predominantly backward-looking and deregulatory in nature. By attempting to eviscerate so many of the critically important reforms summarized above—weakening oversight of private securities markets and reforms; watering down provisions intended to expand fiduciary obligations to investment professionals; lowering standards for securities sold to the investing public; diluting rules that keep “bad actors” out of our securities markets, among many others—the legislation blithely aims to sweep away in one stroke scores of essential protections and modernizations to our financial regulatory architecture that were literally decades in the making.

In sum, state securities regulators are deeply concerned that, if enacted in its current form, the Financial Choice Act would dramatically change regulatory policies in the wrong direction, weakening the important reforms and protections put in place in response to the financial crisis, and exposing investors and the securities markets to significant, unnecessary and new risks.

### **III. Provisions Affecting Investors and Securities Markets**

The legislation and policy changes embodied in the Financial Choice Act are far too vast to address comprehensively in my statement today. Indeed, so numerous and extensive are the revisions contemplated by the bill that I will not be able to fully or comprehensively address even those of the bill’s provisions that are of direct interest to NASAA and state securities regulators. I will use the remainder of this statement to highlight for the Committee several provisions that NASAA considers to be of utmost interest and importance, and to furnish some analysis of the impact of the provisions. In certain cases, where NASAA has previously commented on a particular provision, I will simply note this fact in my statement and provide appropriate citations so that the Committee may easily access the relevant commentary for the record.

#### **A. Provisions Relating to Enforcement & Regulatory Authority**

The Financial Choice Act would make it more difficult for state securities regulators and other regulatory and law enforcement agencies to police U.S. securities and other financial markets to protect investors from fraudulent and abusive practices. NASAA appreciates that the bill does include some provisions that stand to enhance the ability of the SEC to impose meaningful civil penalties for certain violations of securities laws. However, when viewed in their totality, it is clearly evident that the changes contemplated by the bill would significantly undermine and compromise regulators’ ability to effectively enforce financial laws and regulations.

### ***Section 391. Joint Investigations and Enforcement Actions***

Section 391 is overbroad and misguided in including State authorities as part of efforts to minimize duplication of enforcement efforts; therefore, the reference to “State authorities” should be removed. Section 391 seeks to require federal agencies, including the SEC, to implement policies to (1) minimize duplication between federal and state authorities in bringing enforcement actions; (2) determine when joint investigations and enforcement actions are appropriate; and (3) designate a process to establish a lead agency for joint investigations and enforcement actions. Section 391’s reference to “State authorities” is both unnecessary in light of the existing voluntary collaboration, described below, as well as wholly unworkable because of Supreme Court case law that delineates state and federal authority in law enforcement.

In the realm of securities regulation, state and federal securities regulators currently 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 or warrants collaboration;<sup>1</sup> and other initiatives, such as Memorandums of Understanding (“MOUs”). Recently, in conjunction with new rules to facilitate intrastate crowdfunding offerings and regional offerings taking effect, the SEC and NASAA signed an information-sharing MOU.<sup>2</sup> The agreement is intended to facilitate the sharing of information to ensure that the new exemptions are indeed serving their intended purposes of facilitating access to capital for small businesses. Such collaborative efforts are long-standing. For example, from 2011 to 2013, the SEC and state securities regulators worked closely to facilitate and streamline the process by which 2,100 investment advisers transitioned, pursuant to the Dodd-Frank Act, from federal to state oversight.<sup>3</sup>

This current system of voluntary collaboration ensures that resources are focused on productive collaboration, rather than working through federal bureaucratic processes and red-tape before the actual work can begin. Furthermore, voluntary collaboration can be based on the needs of a situation and take geography into account. Not every state has a federal securities regulatory presence, but every state has a state securities regulator, ensuring a boots-on-the-ground approach wherever a bad actor may be perpetrating fraud. Voluntary collaboration ensures that the jurisdictional reach of federal and state securities regulators remains unhindered and that harmful conduct is addressed in a direct and efficient manner without the need to work through federal bureaucratic obstacles.

NASAA has great concerns about hampering this voluntary state-federal collaborative framework through Section 391 as written, which could result in the SEC’s Washington bureaucracy being imposed at the state and regional level. In addition to being inefficient, Section 391’s inclusion of “State authorities” is opposite to the Supreme Court’s holding in *Printz v. United States*, which upholds the separation between federal and state authority. Specifically, in *Printz*, the Court held that the federal government could not compel state law enforcement offices to participate in a federal handgun regulation program.<sup>4</sup> Therefore, the SEC would be unable to impose its policies and procedures on state securities regulators. The current voluntary collaboration between state and federal securities regulators is far preferable to applying Section

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<sup>1</sup> This type of collaboration generally requires formalizing the relationship through access letters and other joint memoranda.

<sup>2</sup> See “SEC, NASAA Sign Info-Sharing Agreement for Crowdfunding and Other Offerings.” Press Release. Feb. 17, 2017, Available at <https://www.sec.gov/news/pressrelease/2017-50.html>.

<sup>3</sup> For additional information see NASAA report entitled “A Successful Collaboration to Enhance Investor Protection,” Available at <http://www.nasaa.org/23169/ia-switch-report/>.

<sup>4</sup> *Printz v. United States*, 521 U.S. 898, 935 (1997).

391 to state securities regulators. Striking references to “State authorities” is necessary to improve Section 391.

### ***Section 827. Elimination of Automatic Disqualifications***

Section 827 should be stricken because it would undo important investor protection reforms. 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 to exclude bad actors from utilizing the Regulation D, Rule 506 exemption (“Rule 506”). These unregistered private offerings naturally have become a favorite vehicle for unscrupulous promoters, who use the Rule 506 exemption to fly under the radar. As required by the Dodd-Frank Act, the SEC in 2013 adopted rules prohibiting bad actors from relying on the Rule 506 exemption.<sup>5</sup>

In contrast to the sound policy of Dodd-Frank Section 926, the Financial Choice Act’s Section 827 is baffling and misguided in its attempt to prohibit the SEC from automatically disqualifying from registration or from using a registration exemption bad actors; namely, a universe of persons the bill expressly defines to include persons “having been convicted of any felony or misdemeanor or made the subject of any judicial or administrative order...[or]...having been suspended or expelled from membership in, or suspended or barred from association with a member of a registered national securities exchange.”<sup>6</sup> The effect of this provision would be to undermine the “bad-actor” disqualifications currently applicable to Rule 506 and other securities offerings.

This provision runs contrary to sound public policy and plain common sense. If enacted, this provision would create procedural burdens to necessary disqualifications, allowing bad actors to continue to rely on exemptions, registrations, and activities that led to those bad acts.

There is simply no valid basis for tying the hands of the SEC or any other securities law-enforcement agency in the manner contemplated by this provision.

### ***Section 823. Private Parties Authorized to Compel the SEC to Seek Sanctions by Filing Civil Action***

Section 823 was introduced in the 114th Congress as H.R. 3798, the Due Process Restoration Act of 2015. As NASAA commented previously,<sup>7</sup> this provision seeks to broadly undermine the efficacy of the federal securities law enforcement framework by providing all respondents in SEC enforcement cases with the right to have their case removed out of the SEC’s administrative authority to a federal district court and. The right to remove would apply not only to unregulated respondents, but to entities directly regulated by the SEC, such as brokerage firms, investment advisers, investment companies, and persons associated with such entities. The provision would create a similar right of removal for persons who are subject to an SEC cease and desist order. Finally, for cases that remain within the purview of an SEC Administrative

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<sup>5</sup> See Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, SEC Release No. 33-9414, 78 Fed. Reg. 44729 (July 24, 2013).

<sup>6</sup> Sec. 827 (P. 448).

<sup>7</sup> See Letter from Judith Shaw, Maine Securities Administrator and NASAA President, to the Hon. Jeb Hensarling, Chairman, House Committee on Financial Services and the Hon. Maxine Waters, Ranking Member, House Committee on Financial Services, dated Mar. 2, 2016 available at [nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-Re-3-2-16-HFSC-FC-Markup-March-2-2016.pdf](https://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-Re-3-2-16-HFSC-FC-Markup-March-2-2016.pdf).

Law Judge, the provision would raise the burden of proof from the “preponderance of the evidence” standard to a higher bar at the “clear and convincing evidence” level.<sup>8</sup>

The SEC has possessed the authority to seek civil monetary penalties in enforcement actions since Congress enacted the Securities Remedies and Penny Stock Reform Act of 1990.<sup>9</sup> In 2010, as part of the Dodd-Frank Act, Congress granted the SEC broader authority to impose civil monetary penalties in administrative proceedings. Section 929P of Dodd-Frank, amended Section 8A of the Securities Act, Section 21B(a) of the Securities Exchange Act, Section 9(d)(1) of the Investment Company Act, and Section 203(i)(1) of the Investment Advisers Act to permit the imposition of civil monetary penalties in administrative proceedings, in addition to the cease-and-desist orders previously available to the SEC.

The authority to pursue remedies for alleged violations of federal securities laws in an administrative proceeding is an important tool in the SEC’s arsenal and furthers the agency’s mission to protect investors. The likely impact of Section 823 on the SEC’s ability to effectively police wrongdoing would be significant and would likely not only reduce the overall number of enforcement actions pursued by the SEC but the deterrent effect that comes with an effective enforcement program. Further, because SEC enforcement actions brought as administrative proceedings often conclude more rapidly than those brought in federal district court, and because they consume fewer federal resources than enforcement actions brought in the federal courts, the bill would serve to make future SEC enforcement actions significantly costlier to the SEC and the government.

Again, there is no valid basis for tying the hands of the SEC or any other securities law enforcement agency in the manner contemplated by this provision.

#### ***Section 820. Advisory Committee on Commission’s Enforcement Policies and Practices***

NASAA is troubled by Section 820 of the bill, which provides for the establishment of an “advisory committee on the Commission’s enforcement policies and practices.” State securities regulators know firsthand the importance of strong enforcement programs free of influence from the regulated entities subject to their oversight. As envisioned by the bill, the Advisory Committee would conduct analysis and make recommendations on the Commission’s policies and practices, which will include direction regarding the appropriate blend of regulation, publicity, and formal enforcement actions, criteria for the selection and disposition of actions, and the suitability and effectiveness of sanctions imposed by Commission proceedings. This Advisory Committee would include up to seven members, including a Chair, each designated by the SEC Chairman.

As proposed, this new Advisory Committee has the potential to hinder and unduly limit the Commission’s ability to investigate and pursue securities fraud and other misconduct. It would compromise the independence of the Commission’s staff and could, over time, serve to institutionalize a degree of “regulatory capture” through the appointment to the Committee of members with perspectives and allegiances that do not fully align with the mandate of the SEC.

#### ***Subtitle A—SEC Penalties Modernization***

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<sup>8</sup> The SEC has traditionally applied a “preponderance of the evidence” standard to administrative enforcement actions.

<sup>9</sup> Initially, the SEC’s authority to seek such penalties in administrative proceeding was limited to regulated entities or persons associated with a regulated entity—brokerage firms, investment advisers and investment companies. In order to obtain monetary penalties against other persons, the SEC was required to pursue a civil action in federal district court.

Federal securities laws limit the amount of civil penalties that the SEC can impose on an institution or individual. NASAA supports provisions included in the Financial Choice Act that would update and strengthen the SEC's authority to impose civil penalties for securities law violations, including by directly linking such penalties to the scope of harm and associated investor losses, increasing the statutory limits on monetary penalties, and increasing the cap for repeat securities law violators.

### ***Subtitle R—Senior Safe***

Subtitle R is comprised of bipartisan legislation introduced and passed by the House during 114<sup>th</sup> Congress as the SeniorSafe Act.<sup>10</sup> The SeniorSafe Act consists of several essential features that improve protections for persons aged 65 and older from financial exploitation by increasing the likelihood it will be identified by financial services professionals and reported to state securities regulators and other appropriate governmental authorities who can help stop it. Specifically, the SeniorSafe Act promotes and encourages financial services professionals, who are positioned to identify and report “red flags” of potential exploitation, to report suspected elder financial exploitation. The provision would incentivize financial services employees to report any suspected exploitation by making them immune from any civil or administrative liability arising from such a report, provided that they exercised due care, and that they make these reports in good faith. Second, in order to better assure that financial services employees have the knowledge and training they require to identify “red flags” associated with financial exploitation, the bill would require that, as a condition of receiving immunity, financial institutions train certain personnel regarding the identification and reporting of senior financial exploitation.

NASAA has supported the SeniorSafe Act since its introduction in 2015, and we continue to strongly support its passage.

## **B. Provisions Relating to Capital Formation**

The Financial Choice Act incorporates more than a dozen distinct legislative proposals pertaining to capital formation, including numerous proposals that resemble legislation considered by the Committee earlier this year and during the 114<sup>th</sup> and 113<sup>th</sup> Congress. NASAA has commented extensively on many of these past proposals, so I will focus my statement on what we view as some of the more significant proposals. However, to the extent that NASAA has previously commented on a proposal that is not addressed in my statement, I would strongly encourage interested members of the Committee to review the relevant information, as it appears on NASAA's website and in the Committee's own records.<sup>11</sup>

### ***Subtitle N—Private Placement Improvement***

The Private Placement Improvement provision in Section 466 of the bill would prohibit the SEC from adopting proposed rules to implement common sense reforms for Regulation D, Rule 506 offerings. As NASAA has testified on several prior occasions, state securities regulators oppose any action by Congress to further diminish the ability of the SEC to address investor protection concerns associated with these offerings or gather quantitative and qualitative data in the private marketplace.

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<sup>10</sup> The Senior Safe Act of 2016 (H.R. 4538) passed the House of Representatives by voice vote on July 05, 2016. (H. Rept. 114-659).

<sup>11</sup> NASAA testified to the House Financial Services Committee and its subcommittees regarding legislative proposals aimed at facilitating capital formation on three occasions during the 113<sup>th</sup> and 114<sup>th</sup> Congress, including on April 14, 2016, May 1, 2014, and October 23, 2013. During the same period, NASAA submitted numerous statements and comment letters addressing legislation relating to “capital formation” under consideration by the Committee. Copies of all such testimony, statements, and comment letters may be accessed on NASAA's website at [nasaa.org](http://nasaa.org).

Title II of the Jumpstart Our Business Startups Act of 2012 (“JOBS Act”) repealed the long-established prohibition on general solicitation and advertising of securities offered under Rule 506. When the SEC adopted rules to implement Title II, on July 10, 2013, it also voted to propose rules that could improve the transparency and mitigate the risk to ordinary investors who participate in Rule 506 offerings, including a requirement to pre-file the “Form D” notice when issuers intend to advertise such offerings to the general public. The SEC’s proposal would also impose meaningful penalties on issuers who fail to file a Form D.<sup>12</sup> Section 466 would effectively prohibit the Commission from adopting these modest proposals.

Proponents have opposed a Form D filing requirement prior to conducting a Rule 506 offering, and again upon the completion of the offering, arguing that multiple filings would impose an onerous compliance burden. Form D, however, is a short form, capturing basic information about the issuer (e.g., business address, officers, directors, business type, etc.). The amount of information required on the Form D relative to the information contained in an issuer’s private placement memorandum or offering document is minimal yet vital to regulators and potential investors. These additional, modest filing requirements are particularly important in understanding the \$1 trillion market in unregistered Regulation D, Rule 506 securities.

State securities regulators, pursuant to their antifraud authority, are the de facto primary regulators of offerings conducted under Regulation D, Rule 506. Fraudulent offerings involving Rule 506 offerings are routinely among the most frequently reported by state securities regulators. We believe it would be a mistake for Congress to weaken the few existing investor protections in Rule 506, and we urge the Committee to reject Subtitle N.

#### ***Subtitle L—Main Street Growth***

The Main Street Growth provision would amend the Securities Exchange Act to provide a framework for a national securities exchange to elect to be treated as a “venture exchange,” which the bill would define as a “market place or facilities for bringing together purchasers and sellers of venture securities.” The venture exchange, as currently envisioned, would function in parallel with traditional public markets for companies under \$2 billion in value. The bill would also create a new class of security—a venture security—that would be listed and traded only on venture exchanges. These venture securities would be exempt from a significant number of regulatory requirements, and presumably subject to significantly diminished listing standards.<sup>13</sup>

The securities listed on the venture exchange could include securities not presently listed on a national exchange, and transacted only on an over-the-counter (“OTC”) basis, as well as securities listed on a national securities exchange as an “emerging growth company.” One of the most notable common features of these types of securities, however, is that they are prone to illiquidity. To manufacture additional liquidity for such securities, this provision would exempt them when listed on a venture exchange from various reporting and disclosure requirements, and would establish new trading rules specifically for securities on venture exchanges, including rules that would allow higher tic-sizes.

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<sup>12</sup> Amendments to Regulation D, Form D and Rule 156, SEC Release Nos. 33-9416, 34-69960, IC-30595. 78 Fed. Reg. 44806. (2013, July 24). Retrieved from [gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm](http://gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm).

<sup>13</sup> Under Subtitle L, securities listed on a venture exchange would be exempt from SEC Regulations ATS and NMS, Decimalization, Sarbanes-Oxley, and State Blue Sky laws.



NASAA has previously questioned the need for new legislation to establish a new venture exchange.<sup>14</sup> Current law allows for the creation of new exchanges, including exchanges targeted to smaller companies. Today, there are many national exchanges registered with the SEC that operate with varied listing requirements. In addition to traditional national exchanges, various alternative marketplaces exist, such as the OTCQX, OTCQB, and OTC Pink. It is not clear why, or if, new legislation or regulatory relief would be necessary to foster the creation of such an exchange in light of existing exchanges.

Further, it is far from certain that any venture exchange will be created, or succeed, with the enactment of this provision. Venture exchanges have existed in the past and have fared poorly. Over the past 80 years, more than 20 regional stock exchanges have gone out of business or merged with other exchanges to stay afloat. While state securities regulators do not oppose the establishment of a new venture exchange provided there are sufficient safeguards for investors, serious questions remain about the challenges to making such exchanges a successful proposition in the United States. Moreover, to the extent any securities traded on such an exchange would receive federal covered status, the exchange must have rigorous listing standards to provide protections ordinarily afforded under state Blue Sky laws.

To the extent Congress proceeds with legislation that would prescribe the establishment and structure of a U.S. venture exchange, NASAA recommends that Congress proceed in a manner that allows for adequate attention to several critical and specific considerations, summarized below.<sup>15</sup>

First, retail investors will be a primary source of capital for a venture exchange, which immediately raises investor protection concerns. A venture exchange likely will significantly rely on retail investors, including passive and “self-directed” retail investors, to support a market for the securities traded on the exchange, because many institutional investors simply do not invest in smaller and more speculative issues such as those that would likely be listed on a venture exchange.<sup>16</sup> Indeed, while it is unclear how venture exchanges would augment the many tools already available to provide capital to businesses, it is readily evident that establishing such exchanges could pose significant risks to investors. The central features of the proposed venture exchange—newer, untested companies, reduced disclosure, limited liquidity, and comparatively high rates of failure or bankruptcy and investment loss—sharply contrast with the robust disclosure and transparency regime that define America’s modern and efficient capital markets.

Second, appropriate listing standards will be essential to a successful venture exchange. To be successful, a U.S. venture exchange will need to attract and sustain interest from issuers, retail investors, brokers, analysts, and other market participants, as well as some institutional capital. Sustained interest

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<sup>14</sup> See Written Statement of William Beatty, NASAA President and Washington Securities Division Director, delivered to the Subcommittee on Securities, Insurance and Investment of the Senate Committee on Banking, Housing and Urban Affairs, “Venture Exchanges and Small-Cap Companies,” Mar. 10, 2015, *available at* [www.nasaa.org/34863/venture-exchanges-and-small-cap-companies](http://www.nasaa.org/34863/venture-exchanges-and-small-cap-companies).

<sup>15</sup> Unfortunately, only one hearing on the topic of venture exchanges has been held by the House Financial Services Committee in recent years—a subcommittee hearing in early 2015—and that hearing focused on a number of bills, one of which related to a venture exchange. The Committee needs to further explore the many challenges to establishing a venture exchange. While additional study could be helpful and even decisive in assuring the long-term prospects of a venture exchange effort, the Committee is advancing a concept that has not been fully analyzed and explored.

<sup>16</sup> There may be a variety of reasons that institutional investors tend not to invest in smaller issues such as those likely to be listed on a venture exchange. Some obstacles, such as potential illiquidity and lack of research coverage, may be attenuated by a venture exchange with robust listing standards. Other obstacles seem likely to persist, particularly as they relate to the size of the issues themselves. For example, the low market capitalization of the issues listed on a venture exchange may make it difficult for institutional investors to invest in them profitably, or to buy them in the ordinary course of their business activities without pushing the stock price up appreciably.

will require robust listing and disclosure standards to facilitate brokers recommending investments in securities traded on a venture exchange. When recommending investments to retail clients, brokers rely on disclosures to meet their suitability responsibilities. A venture exchange without reliable disclosure and governance requirements will face additional challenges as brokers could be unable to meet their suitability responsibilities to their clients. Similarly, inadequate listing standards will impose a major barrier to investments of assets from individual retirement accounts (“IRAs”) and other tax-deferred retirement accounts, which may become subject to the fiduciary standard later this year.

In NASAA’s view, among the flaws of this provision is a lack of listing standards. At the very least, the legislation must be amended to require listing standards governing reporting, auditing, accounting, due diligence, management, and corporate governance. As a general principle, the listing standards of a successful venture exchange should be as rigorous as possible without compromising the ability of the exchange to scale its requirements to reasonably reduce costs and attract listings. In addition, there should be a mechanism to remove companies that fall below the listing standards.<sup>17</sup> Finding the appropriate balance is challenging but absolutely crucial in establishing a venture exchange.

In any effort to develop legislation to establish a new venture exchange, Congress should account for the lessons learned from other venture exchange efforts in the United States and elsewhere. There is theoretical potential for a venture exchange to play a useful function in our capital markets, but there are also many valid questions about why, how, and whether such exchanges might succeed in the United States. Congress should study these questions more closely prior to passing legislation establishing such an exchange. In particular, Congress should examine reasons for the demise of the American Stock Exchange Emerging Company Marketplace (“ECM”), as well as the lessons learned from NASDAQ’s efforts to establish a new venture exchange in 2011. Congress also should examine the international experience with venture exchanges, including notably Canada’s TSX Venture Exchange, and the Alternative Investment Market (“AIM”) in the United Kingdom. As former SEC Commissioner Luis Aguilar has noted, there is considerable evidence that these and other international venture exchanges are continuously plagued by low liquidity, and at times high volatility.<sup>18</sup> In NASAA’s view, Congress should strive to understand the underlying causes of such problems prior to establishing similar exchanges in the United States.

Finally, and perhaps most importantly, venture exchanges have the potential to be very risky for certain investors. No matter how effective the regulatory scheme for a venture exchange, securities that trade on such proposed exchanges will be significantly riskier investments than securities issued by public companies traded on a major national exchange. Congress should thoroughly examine all issues NASAA and other commenters have raised regarding venture exchanges prior to advancing this or any similar legislation.

### ***Subtitle S—National Securities Exchange Regulatory Parity***

The National Securities Exchange Regulatory Parity provision would amend Section 18 of the Securities Act of 1933 to allow the SEC to recognize any exchange of any size or quality as a “national

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<sup>17</sup> Shell or non-operating companies, for example, are often a mechanism for fraud. Indeed, since 2012, the SEC has suspended trading of more than 800 microcap stocks. Press Release, SEC, SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters (March 2, 2015), available at <https://www.sec.gov/news/pressrelease/2015-44.html>.

<sup>18</sup> Remarks of Commissioner Luis Aguilar, Meeting of the SEC Advisory Committee on Small and Emerging Companies, Mar. 4, 2015, available at [sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html](https://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html).

securities exchange.” All securities listed on such exchanges would be covered securities and not subject to state registration laws.

NASAA strongly opposes this proposal, which threatens the core tenets of modern securities market regulation. Under existing law, a listing on a national securities exchange affords such securities covered security status such that state registration requirements are preempted.<sup>19</sup> A balance was struck regarding the level of rigorousness in listing standards that would afford such covered security status and preemption of state law in 1996, with the enactment of the National Securities Markets Improvement Act (“NSMIA”). The benchmark for preemption established by Congress under NSMIA is that an exchange must have rigorous listing standards comparable to those of the major national stock exchanges, such as the New York Stock Exchange (“NYSE”), or have “substantially similar” listing standards, as the SEC may determine by rule. The rationale is that investors purchasing securities listed on an exchange that has sufficiently rigorous listing standards do not require the added protection afforded by Blue Sky registration.<sup>20</sup> This bill would upend the balance struck in NSMIA and remove vital investor protections afforded by state securities laws that would otherwise be applicable.

Given the number and variety of exchanges currently in existence, it is not clear why this provision is necessary.<sup>21</sup> Further, current law allows the creation of exchanges with varied listing requirements, including alternative marketplaces.<sup>22</sup> By removing the statutory references to recognized national securities exchanges like the NYSE, and the attendant requirement that all national securities exchanges with covered security status maintain meaningful listing standards that are substantially similar to such major exchanges, this language undercuts the distinction between national exchanges with rigorous listing standards and all other exchanges, including local or regional exchanges with no regard to the applicable listing standards. It also creates confusion with alternative trading systems, a secondary trading platform.<sup>23</sup> Ultimately, this provision will create adverse marketplace confusion and impact the quality of securities listed on recognized national exchanges.

#### ***Subtitle M—Micro-Offering Safe Harbor***

The Micro-Offering Safe Harbor provision seeks to amend Section 4 of the Securities Act to create a new exemption from registration for an offering that meets the following three criteria: (1) each purchaser has a substantive pre-existing relationship with an officer or director of the issuer, or with a shareholder holding 10 percent or more of the issuer’s shares; (2) there are no more than 35 purchasers of securities from the issuer in reliance on this exemption during the preceding 12 months; and (3) the aggregate amount raised by the issuer during the 12-month period preceding the transaction, including in reliance on this exemption, does not exceed \$500,000. The bill also preempts state regulation of these proposed securities offerings, and does not prohibit general solicitation, disqualify bad-actors, limit offering amounts (for instance, to unaccredited investors), or permit any notice filings to state and federal regulators.

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<sup>19</sup> Exchanges with less stringent listing standards (e.g., the Miami International Securities Exchange) do not provide “covered” status.

<sup>20</sup> See Section 18(b)(1)(A)-(B) of the Securities Act of 1933 and Rule 146.

<sup>21</sup> There are currently 19 national securities exchanges registered with the SEC, and ten recently approved securities exchange applications. See [sec.gov/divisions/marketreg/mrexchanges.shtml](http://sec.gov/divisions/marketreg/mrexchanges.shtml).

<sup>22</sup> Various alternative marketplaces currently exist, such as the OTCQX, OTCQB, and OTC Pink. In fact, OTC Markets refers to the OTCQB as “The Venture Marketplace.”

<sup>23</sup> If an entity is conducting secondary trading and meets the criteria of a national securities exchange, they must register under Section 6 of the Securities Exchange Act of 1934. An entity that does not meet the criteria of a national securities exchange, depending on their activities and trading volume, may alternatively register as a broker-dealer and comply with Regulation ATS.

This new exemption would create an overly broad federal exemption that would allow public solicitation and sales to any investor regardless of sophistication or financial wherewithal, subject only to the requirement that there be a previously existing relationship—a standard that is not difficult to establish. We also question why an issuer would need to engage in public solicitation if it had a previously existing relationship. Further, the practical necessity of the proposed exemption remains unclear—just as basic questions about what issuers it would serve remain unanswered. In fact, there are already several provisions at the state and federal level that small, microcap issuers can rely upon for limited offerings.<sup>24</sup> Congress should consider the relationship between this new proposed exemption and the popular, existing exemption—Rule 506(b)—that allows an issuer to sell its securities to up to 35 non-accredited, sophisticated, investors.<sup>25</sup>

This proposed exemption would preempt state authority to register or review securities offerings that are by their nature local, state-based offerings. Without effective regulatory oversight, provisions such as this one will not succeed. Preemption of state review and registration for this type of small localized offering would serve only to handcuff the very regulators best positioned to oversee these smaller, local offerings. In short, there is no valid public policy basis for Congress to prevent state officials and their constituents from making decisions about the purely local or regional issuers that would likely rely on this provision.

### ***Subtitle P—Fix Crowdfunding***

Subtitle P of the Financial Choice Act would enact a wholesale revision of Title III of the 2012 JOBS Act, which took effect less than a year ago, on May 16, 2016. State securities regulators appreciate Congress's continued interest in federal crowdfunding but believe that Congress should wait until the framework has matured and there is a sufficient record in place before making changes to the crowdfunding law. This is particularly important given the significant overhaul contemplated in this section of the Financial Choice Act.

It is still too early to determine what changes are needed to improve or “fix” federal crowdfunding as there is limited available data. Moreover, enacting a wholesale replacement of federal crowdfunding runs contrary to the work entailed by Congress in drafting Title III of the JOBS Act, and extensive SEC rulemaking to implement Title III. The final federal crowdfunding provisions represent a balance struck by Congress to encourage small business capital formation while also protecting investors.

State securities regulators agree that small businesses are important to job growth and to the continued improvement of the overall economy. In fact, as of today, 33 states plus the District of Columbia have passed state-based crowdfunding laws and other limited offering exemptions. Numerous small businesses rely on those laws to raise money and further their business objectives. Nevertheless, state securities regulators have concerns with proposed Subtitle P. First, it removes individual and aggregate investment caps. As NASAA commented during Congressional consideration of the JOBS Act, one of the fundamental tenets of securities law is to require securities sellers to disclose sufficient information to investors to protect and allow them to make informed decisions. Post-sale antifraud remedies provide little

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<sup>24</sup> For example, an issuer can raise funds under Rule 504, Section 3(a)(11) of the Securities Act of 1933 (“1933 Act”) and its safe harbor Rule 147, and Section 4(a)(2) of the 1933 Act. Most states also have de minimus offering exemptions, allowing issuers to raise money with a limited number of purchasers through self-executing exemptions with little or no notice filing requirements. Finally, amendments recently finalized by the SEC to Rules 147 and 504 will significantly increase the utility of those exemptions. Small issuers can similarly rely on federal crowdfunding rules and Regulation A.

<sup>25</sup> Under 506(b), however, the non-accredited investors must nevertheless be sophisticated, must receive a disclosure document containing certain information, and cannot be solicited via general solicitation.

comfort to an investor who has lost a significant sum of money that is unrecoverable. In the case of federal crowdfunding, investors are largely unaccredited and many are unsophisticated or first-time investors. Given that most U.S. households have a relatively modest amount of savings, eliminating the cap can expose many more American families to potentially crippling financial harm. Similarly, no cap on the aggregate investment amount makes this provision inconsistent with the expressed rationale for the crowdfunding exemption. A company wanting to raise large sums of investment capital must do so consistent with the laws applicable to such an endeavor, including the registration and filing requirements.

Subtitle P also would allow an issuer to conduct federal crowdfunding without a registered intermediary (an important gateway protection when unsophisticated investors are being solicited), and removes a significant amount of the currently existing regulatory requirements on intermediaries and issuers that protect investors. For example, it removes the requirement that an intermediary protect the privacy of information collected or that an issuer provide a description of its financial condition including certain tax returns and other financial statements. It removes many required disclosures to investors and ongoing reporting to the SEC, and removes all liability for material misstatements and omissions. It also fails to prohibit directors, officers, or partners of an intermediary from having a financial interest in an issuer. Finally, this language amends the current federal crowdfunding regime by prohibiting a state from imposing any fees under authority reserved to the states. While states argued that their registration and review authority should not be preempted under Title III of the JOBS Act, Congress reserved to the states their full enforcement authority, including the imposition of fines or related fees, and the authority to require notice filings and fees. Any attempt to prevent states from collecting fees or imposing fines for improper conduct is misguided, and restricting a state's enforcement authority completely undermines the deterrence that comes with such authority.

This rewritten federal crowdfunding bill will further delay the maturation of this new marketplace, and implement worrisome and dangerous provisions that strip the carefully considered Title III of many of its investor protections. The bill prevents state securities regulators from ensuring that investors do not lose significant and unrecoverable savings. If Congress is poised to enact policies intended to strengthen the economy, this provision will have precisely the opposite effect.

#### ***Subtitle H—Small Business Credit Availability***

As NASAA has testified extensively in the past,<sup>26</sup> Subtitle H would relax portfolio strictures, leverage limits, and other regulations for business development companies (“BDCs”). BDCs are regulated, closed-end investment firms that invest in small, developing or financially troubled companies. Although governed by the Investment Company Act of 1940 (“ICA”), BDCs are unique in that they enjoy a number of important exemptions from the ICA. For instance, BDCs are permitted to use more leverage than a traditional mutual fund—up to and including a 1-to-1 debt-to-equity ratio, and BDCs can engage in affiliate transactions with portfolio companies. BDC managers also have access to “permanent capital” that is not subject to shareholder redemption. In exchange for such regulatory latitude, BDCs must adhere to certain portfolio strictures not applicable to other registered funds. Most prominently, BDCs are required to maintain an asset coverage ratio of 200%, at least 70% of which must be in certain “eligible” investments. In addition, under Section 12(d)(3) of the ICA, a BDC generally cannot acquire securities issued by a broker-dealer, an underwriter or an investment adviser of an investment company, or a registered investment adviser, except under limited circumstances.

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<sup>26</sup> See Letter from Judith Shaw, Maine Securities Administrator and NASAA President, to the Hon. Jeb Hensarling, Chairman, House Committee on Financial Services and the Hon. Maxine Waters, Ranking Member, House Committee on Financial Services, dated Nov. 2, 2015 available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-to-HFSC-Regarding-November-3-2015-Markup.pdf>

Subtitle H would alter the restrictions currently imposed on BDCs. It would allow BDCs to invest in investment advisers and an “eligible portfolio company” that includes a list of enumerated investment companies, other than a private equity company or hedge fund, thus resulting in a diversion of BDC funds from the companies that BDCs were intended to benefit. NASAA appreciates that language in the provision permits the SEC to address potential conflicts of interest with investment advisers, but remains concerned about such conflicts. For example, if an advisory firm were among a BDC’s portfolio of companies, an incentive could exist for the investment adviser to recommend, or even push, clients toward investments in the BDC or its other portfolio companies. Such conflicts of interest could be even more troublesome in the context of an investment adviser’s discretionary or “managed” accounts, where the adviser is delegated authority to make investment decisions on behalf of the client. These inherent conflicts could interfere with an investment adviser’s fiduciary obligations to its clients and the BDC as a shareholder. Finally, such conflicts may allow a BDC to access the advisory firm’s pool of capital to shore up an underperforming portfolio company. No such conflicts of interest exist now, and NASAA urges Congress not to enact legislation that would create such conflicts as it considers reforms to BDC portfolio strictures.

The proposed language also would have an adverse impact on BDC transparency and increase the risk to retail investors. It would redefine an eligible portfolio company as almost any type of investment company, other than a private equity company or hedge fund, and provides that a BDC may invest up to 50% of its “total assets” (20% more than currently allowed) in any type of eligible or non-eligible company. Because BDCs are frequently “blind pool” offerings, retail investors may only receive broad, vague disclosures about the underlying investment portfolio. It is these retail investors who would bear the loss if the BDC invested in riskier products such as payday lenders and installment programs, REITS, or other structured products.

Finally, NASAA continues to question the rationale for further expanding the leverage limits applicable to BDCs. Excessive leverage comes with increased risk as was the case with many of the largest financial institutions that had to be bailed out by the federal government during the financial crisis. Adjusting the leverage limits applicable to BDCs has inherent potential to put retail investors at significantly increased risk. If Congress ultimately concludes that a modest adjustment to BDC asset coverage ratios for well-established BDCs is in order, it should carefully consider the increased risks that such changes could create for retail investors, and examine what, if any, steps can be taken to mitigate such risks.

#### ***Subtitle T—Private Company Flexibility and Growth***

Section 12(g) of the Securities Exchange Act of 1934 was enacted to ensure that as companies grew and became more complex, so would their disclosures to investors, such that ultimately companies could not avoid becoming public reporting companies once their assets and shareholder base reached a certain threshold. Already creative shareholder recording methods (such as “beneficial” shareholders relying on brokers, banks and other intermediaries) allow companies to avoid mandatory reporting. The JOBS Act increased the shareholder threshold from securities “held of record” by 500 persons, to securities “held of record” by either 2,000 persons, or 500 persons who are not accredited investors. That law also exempted crowdfunding investors and for purposes of the shareholder threshold calculation as well as securities held by shareholders under employee compensation plans. This provision of the JOBS Act is often overlooked but has played a role in the expansion of the private markets to the detriment of the public IPO markets.

Further increasing this threshold under Subtitle T (both for Section 12(g) registration and deregistration) would allow even more private companies to avoid public reporting and rely on existing exemptions from registration (i.e., Rule 506 of Regulation D, Regulation A, crowdfunding) when issuing shares. Subtitle T also removes the 500 non-accredited investor threshold, thus allowing a company to have up to 2,000 non-accredited investors who do not have the benefits of a public reporting company. These

benefits include enhanced transparency (e.g., publishing quarterly reports, holding shareholder meetings, etc.), allowing retail investors to participate in the economy and grow their wealth, and permitting investors to freely trade their shares.

### ***Subtitle U—Small Company Capital Formation Enhancements***

Subtitle U, “JOBS Act-Related Exemption” would increase the aggregate offering limit under Regulation A+ (Section 3(b)(2) of the Securities Act) from \$50 million to \$75 million and automatically adjust this amount for inflation every 2 years.<sup>27</sup> As with federal crowdfunding, Regulation A+ has not been effective for a sufficient amount of time to make decisions regarding needed adjustments. The Commission adopted final rules on March 25, 2015, and the rules became effective June 19, 2015. It has been less than two years since the rules took effect, and the Commission is still evaluating their effectiveness and considering whether revisions are necessary or prudent. NASAA questions the reasoning behind further increasing the aggregate offering amount and recommends that Congress make those determinations after the market has matured and there is a sufficient regulatory record in place.

### ***Section 860. Definition of Accredited Investor***

NASAA opposes the provisions in Section 860 that would codify the existing income and net worth standards of the accredited investor definition and direct the SEC to establish new untested means for persons to qualify as accredited investors. Such categories would include natural persons who are licensed or registered as a broker-dealer or investment adviser, and natural persons who the SEC determines, by regulation, have “demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment.”

As the Government Accountability Office and others have discussed, dollar thresholds have never been an accurate proxy for investor sophistication.<sup>28</sup> Congress should refrain from embedding such flawed metrics, and new untested criteria, into our nation’s securities laws. Further, on December 18, 2015, the SEC issued a Dodd-Frank Act mandated report on the definition of accredited investor, making recommendations on potential changes.<sup>29</sup> Congress should allow the SEC to review those findings and any staff recommendations, prior to taking steps to codify additional changes to the accredited investor definition.

### ***Sec. 401. Registration exemption for merger and acquisition brokers***

Section 401 of the Financial Choice Act would establish an exemption from registration requirements under federal securities laws for persons serving as brokers in certain merger and acquisition

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<sup>27</sup> Prior to the enactment of the JOBS Act, the offering cap for Regulation A was \$5,000,000. The increase of the offering cap to \$50,000,000 represents a 900% increase in the cap. Raising the cap to \$75,000,000 would represent a 1400% increase from the initial \$5,000,000 cap.

<sup>28</sup> United States Government Accountability Office Report. “Alternative Criteria for Qualifying As An Accredited Investor Should Be Considered.” GAO-13-640. (July, 2013).

<sup>29</sup> Section 413(b)(2)(A) of the Dodd-Frank Act directs the SEC to review the accredited investor definition as it relates to natural persons every four years to determine whether the definition should be modified or adjusted for the protection of investors, in the public interest and in light of the economy. The first report is available at [sec.gov/corpfin/reportspubs/special-studies/review-definitionof-accredited-investor-12-18-2015.pdf](http://sec.gov/corpfin/reportspubs/special-studies/review-definitionof-accredited-investor-12-18-2015.pdf). NASAA submitted a detailed comment letter in response to this recommendation on May 25, 2016, which is available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Accredited-Investor-Comment-Letter-05252016.pdf>.

deals (“M&A brokers”). State securities administrators share Congress’s interest in establishing a more streamlined regulatory framework for persons serving as brokers in M&A deals that involve the transfer of securities, subject to certain conditions, including (1) the disqualification from the exemption of any broker or associated person who is a bad actor, or subject to suspension or revocation of registration; and (2) the inapplicability of the exemption to any M&A transaction where one party or more is a shell company. NASAA supported legislation identical to Section 401 when it was passed by the House as a provision of a broader legislative package in 2016<sup>30</sup> and continues to support the provision. We also note the federal exemption established by Section 401 closely mirrors a recently adopted NASAA Model Rule which exempts M&A brokers from state securities registration pursuant to certain conditions.<sup>31</sup>

### ***Other Capital Formation Sections***

NASAA continues to have questions about additional provisions that impact the capital markets and securities regime.<sup>32</sup>

## **C. Other Provisions of Significant Concern**

In addition to the provisions addressed above, NASAA is concerned with the following provisions in the Financial Choice Act.

### ***Section 841—Retail Investor Protection Act***

NASAA strongly opposes Section 841 of the Financial Choice Act. This provision would, among other things, invalidate the rule recently adopted by the U.S. Department of Labor (“DOL”) until after the SEC issues its own final rule relating to standards of conduct for brokers and dealers, and effectively prevent the DOL from undertaking any future rulemaking regarding the conduct of brokers and dealers in the management of retirement accounts. Section 841 also would impose additional regulatory, analytical, and economic analysis requirements on the SEC prior to any rulemaking. These provisions would only create significant obstacles to any future SEC rulemaking aimed at raising the standards of conduct applicable to broker-dealers.

While the DOL’s fiduciary rule remains distinct from any SEC rulemaking pursuant to Section 913 of the Dodd-Frank Act, NASAA continues to advocate on multiple initiatives to raise the standard of care for the benefit of investors.<sup>33</sup> With Americans living longer and, in many instances, with fewer funds

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<sup>30</sup> See Letter from Judith Shaw, Maine Securities Administrator and NASAA President, to the Hon. Bill Huizenga, dated Feb. 3, 2016 available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-on-Huizenga-Amendment-to-H-R-1675.pdf>

<sup>31</sup> On September 29, 2016, NASAA adopted a Model Rule Exempting Certain Merger & Acquisition Brokers from Registration. The NASAA Model Rule is available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/MA-Broker-ModelRule-adopted-Sept.-29-2015.pdf>

<sup>32</sup> For example, NASAA questions: (a) whether additional investor protections should be included in Subtitle K - Helping Angels Lead Our Startups; (b) the removal of important investor protections in Subtitle G - Enhancing the RAISE Act - which has already been enacted into law; (c) unnecessary delay of enactment of XBRL in Subtitle C - Small Company Disclosure Simplification; (d) substantially increasing the Rule 701 thresholds from a bill that already passed the House in this Congress in Subtitle B - Encouraging Employee Ownership; and (e) expanding the qualifying investor limitation for a qualifying venture capital fund in Subtitle O- Supporting America’s Innovators; among other provisions.

<sup>33</sup> See Letter from Mike Rothman, Minnesota Commerce Commissioner and NASAA President, to U.S. Department of Labor, dated March 16, 2017 available at <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2017/03/20170316-Comment-Letter-to-DOL-re-Rule-Delay.pdf>



available for retirement, it is absolutely essential that fundamental legal protections for the assets they do have are in place in the form of fiduciary laws—such as the Employee Retirement Income Security Act of 1974 and the Investment Advisers Act of 1940. Further, any nullification of the DOL’s fiduciary rule or any attempt to thwart meaningful rulemaking by the SEC would be a profound disservice to investors.

### ***Section 857—Repeal of Authority to Restrict or Prohibit Mandatory Arbitration***

Section 857 of the Financial Choice Act would repeal Section 921 of the Dodd-Frank Act, which was enacted in direct response to Congressional concern that mandatory pre-dispute arbitration agreements were unfair to investors.<sup>34</sup> The provision gives the SEC explicit rulemaking authority to prohibit, condition or limit the use of mandatory pre-dispute arbitration agreements if it finds that doing so is in the public interest and for the protection of investors.

NASAA has long been concerned with the widespread use of mandatory pre-dispute arbitration clauses in customer contracts used by broker-dealers and, more recently, investment advisers as well.<sup>35</sup> Investors must have a choice of forum when it comes to resolving disputes with their investment professionals. Investor confidence in fair and equitable recourse is critical to the stability of the securities markets and long-term investments by retail investors. As NASAA and others have previously noted, participation by “mom and pop” investors in our capital markets, and, by extension, job growth, is directly tied to their level of trust in having a reasonable avenue to seek recovery if they are victimized by securities fraud or other unethical conduct.

While the SEC has not taken action to limit mandatory pre-dispute arbitration pursuant to its authority under Section 921, this does nothing to alter the fact that the recent proliferation in the use of such contracts by investment professionals is fundamentally harmful to many investors. We urge Congress to retain this important authority and remove this language from the bill.

### ***Section 858—Exemption of and Reporting by Private Equity Fund Advisers & Section 859 – Records and Reports of Private Funds***

Sections 858 and 859 of the Financial Choice Act would unnecessarily weaken oversight of advisers to private-equity funds, including by repealing important provisions in the Dodd-Frank Act that require the registration and reporting of advisers to such funds. As recent SEC examinations have revealed, the scrutiny of advisers to private funds is important to the protection of investors in such funds, including limited partners, and even certain state pension funds. The registration of private fund advisers has brought much needed transparency to a significant segment of the markets.<sup>36</sup>

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<sup>34</sup> Congress considered the following concerns about the arbitration process: “high upfront costs; limited access to documents and other key information; limited knowledge upon which to base the choice of arbitrator; the absence of a requirement that arbitrators follow the law or issue written decisions; and extremely limited grounds for appeal.” See Senate Committee on Banking, Housing, and Urban Affairs on S. 3217, S. Rep. No. 111-176, at 110.

<sup>35</sup> See Letter from Secretary William F. Galvin of the Commonwealth of Massachusetts to SEC Chair Elisse B. Walter and SEC Commissioners Tory A. Paredes, Luis A. Aguilar, and Daniel M. Gallagher, dated Feb. 12, 2013, *available at* <http://sec.state.ma.us/sct/sctarbitration/arbitration-letter.pdf> (citing a Massachusetts Securities Division survey to 710 state registered Massachusetts investment advisers, which indicated that of the more than 50% of surveys received, nearly half of the investment advisers included a binding pre-dispute arbitration clause in their advisory contracts).

<sup>36</sup> See Prepared remarks of Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, SEC, Private Equity International (PEI), Private Fund Compliance Forum 2014, New York, NY. (May 6, 2014), *available at* <https://www.sec.gov/news/speech/2014--spch05062014ab.html>.

NASAA strongly urges Congress to refrain from repealing provisions of the Dodd-Frank Act that provide appropriate and overdue scrutiny of advisers to private funds.

### ***Section 332—Congressional Approval Procedure for Major Rules***

Section 332 of the Financial Choice Act would require Congress to pass, and the President to sign, a joint resolution of approval for all major rules published in the Federal Register.<sup>37</sup> This radical provision would upend decades of federal administrative law practices dating back to the 1930s. Its potential to dramatically and adversely impact the ability of regulatory agencies to take actions to implement laws intended to protect the investing public is self-evident. NASAA strongly opposes requiring affirmative Congressional and Presidential approval of regulations, and we similarly oppose any attempt to impose debilitating, unreasonable and unrealistic hurdles on independent agencies engaged in rulemaking.

### ***Section 341—Scope of Judicial Review of Agency Action***

Section 341 would undo nearly two centuries of Supreme Court precedent in which the Court has affirmed that deference to federal agencies is a good jurisprudential practice. The Court's 1984 *Chevron* decision is the most widely recognized case in this regard.<sup>38</sup> But *Chevron* was merely a logical consequence of Court precedents dating as far back as 1827.<sup>39</sup> Deference to federal agencies is good policy because federal agencies, much like a rudder on a ship, provide an inherently stabilizing force to the development of administrative law. Upending the longstanding tradition of agency deference would inevitably result in greater policy discontinuities, to the detriment of American businesses and families.

The conclusion that deference to administrative agencies is ultimately good for the American people is reinforced by the fact that states roundly accept this practice. State legislatures and state courts defer to state administrative agencies on the interpretation of state laws and rules which those agencies administer not because they have to—*Chevron*, of course, does not bind the states—but because they have considered this issue and concluded that deference works. It would be a mistake for the federal government to abort this principle.

### ***Section 811—Duties of SEC Investor Advocate***

NASAA strongly opposes provisions in the Financial Choice Act that would weaken the independence and influence of the SEC's Office of the Investor Advocate. Specifically, Section 811 would restrict the SEC Investor Advocate's authority to express views regarding legislation introduced in Congress, except in regard to a legislative change proposed by the Investor Advocate, and also would require the Investor Advocate to consult and coordinate activities and recommendations with unrelated SEC advisory committees. In NASAA's view, such requirements are unnecessary and would undermine the ability of the Investor Advocate to speak as an independent voice for the interests of retail investors.

### ***Section 831—Complaint and Burden of Proof Requirements for Certain Actions for Breach of Fiduciary Duty***

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<sup>37</sup> Section 334 of the Financial Choice Act defines the term major rule as any rule or interim final rule that the Office of Management and Budget find has resulted in or is likely to result in (A) an annual effect on the economy of \$100 million or more; (B) a major increase in costs or prices for consumers, individual industries, Federal, State or local government agencies; or significant adverse effects on competition, employment, investment, productivity or innovation.

<sup>38</sup> *Chevron v. Nat'l Resources Def. Council*, 467 U.S. 837 (1984).

<sup>39</sup> *Edwards' Lessee v. Darby*, 25 U.S. 206 (1827).

Section 36(b) of the Investment Company Act (ICA) provides mutual fund investors with a cause of action against mutual fund investment advisers that charge investors excessive advisory fees. Section 36(b) is the only private cause of action in the ICA. In 2010, the Supreme Court adopted the so-called *Gartenberg* test as the proper standard for Section 36(b) claims.<sup>40</sup> This test poses a significant hurdle to plaintiffs, who must show that an adviser charged a fee “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”<sup>41</sup>

Section 831 would place two additional burdens on investors by elevating the pleading standard and burden of proof in Section 36(b) claims. This would make it nearly impossible for investors to succeed in 36(b) cases. First, raising the pleading standard will put investors in a Catch-22: they will be required to plead specific facts that show an adviser’s fee was excessive yet they will have no ability at this stage of litigation to discover these facts through subpoenas for documents or testimony. Second, elevating the burden of proof in Section 36(b) claims from a preponderance to clear and convincing evidence standard would put a nearly insurmountable hurdle in investors’ way if they even could successfully plead their claims. Indeed, Section 831 would tip the scales of justice in Section 36(b) disputes strongly in favor of investment advisers, to the detriment of average American retail investors.

#### **IV. Conclusion**

In conclusion, NASAA’s message to Congress is simple and clear: Please continue your commitment to protecting investors and do not undermine the important and overdue reforms implemented in the wake of the financial crisis, either directly through legislative repeals, or indirectly through a lack of appropriate funding or delayed execution. The financial crisis that struck our country is not some distant memory in the minds of hard-working Americans. The distress that comes with the loss of retirement savings built up over many years is devastating. It is, therefore, incumbent upon members of Congress and regulators to demonstrate an unwavering commitment to Main Street investors and continue to take the steps necessary to protect them. Their confidence in knowing that the “cops are on the beat” is integral to the success and integrity of our nation’s markets. NASAA looks forward to working cooperatively with the Committee, as well as all members of Congress and fellow regulators, to ensure Americans continue to benefit from effective regulation, strong investor protection, and robust and transparent capital markets.

Thank you again for the opportunity to provide this statement for the hearing record, and for your consideration of NASAA’s views on the Financial Choice Act.

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<sup>40</sup> *Jones v. Harris Assoc.*, 559 U.S. 335 (2010).

<sup>41</sup> *Id.* at 344.