White Paper

States' Demonstrated Record of Effectiveness In Their Investor Protection Efforts Underscores the Need to Avoid Further Preemption of State Enforcement Authority

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Forward

In the recent Emergency Economic Stabilization Act, Congress authorized a comprehensive review of the current state of the United States' financial regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers. In light of the unprecedented market turmoil this year, there is a demonstrated need for forceful securities regulation in order to protect savers and investors. The purpose of this paper is to remind policymakers of the demonstrated record of effectiveness of state securities regulators over the last ten years and, in particular, how the states have been at the forefront on a number of important investor protection issues. This paper also suggests that any consolidation of the federal regulatory system should be counterbalanced by a recognition of the importance of forceful state securities regulation to investor confidence in our markets and a reaffirmation of the independent role of state securities regulators.

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I. Summary

This paper discusses the central role that state securities regulators have played in securities enforcement over the last ten years. It illustrates how the states have taken the lead in investigating and prosecuting significant occurrences of securities fraud that have victimized retail customers of financial services companies. Section II discusses significant instances of securities fraud over the last ten years, such as the recent failure of the auction rate securities market and the tainted research analyst scandal, and illustrates how it has largely been the states that have initiated enforcement actions resulting in restitution to customers. Section III argues that the tremendous consolidation within the financial services industry after the adoption of the Gramm Leach Bliley Financial Modernization Act in 1999 has had a substantial, and often detrimental, impact on consumers of financial services, but that the effects of that consolidation have not been adequately addressed on the federal regulatory level. It further maintains that the states have effectively responded to the business conduct issues that have arisen and have protected consumers from the effects of the consolidation. Section III also argues that any federal regulatory consolidation that is effectuated in response to the financial consolidation that has occurred is likely to be fundamentally deregulatory and, as such, should be counterbalanced by a strong affirmation of the valuable role states play in securities regulation. Section IV examines the effects of the preemption of state regulatory authority by the National Securities Markets Improvement Act of 1996 and suggests that any further preemption of state regulatory authority would be detrimental to consumers of financial services and for the economy as a whole. Section V concludes by suggesting that securities regulation in this country could be improved by strengthening the coordination and integration of federal and state securities regulators, as long is it is done in a way that preserves the independence of state securities regulators.

II. Demonstrated Record of Effectiveness State Enforcement Efforts

State securities regulators play a vital role in maintaining liquid and resilient capital markets in the United States. State securities regulation predates federal securities regulation and it has endured as part of a complementary state/federal regulatory regime for more than three quarters of a century. Moreover, the presence of both state and federal regulators is largely responsible for the competitiveness of the U.S. capital markets. As one commentator has stated, concurrent federal and state authority over securities regulation "serves as a 'fail safe mechanism,' an additional source of protection if one or the other level of government fails to provide adequate safeguards to the public."[1]

There is a significant record of major abuses over the last ten years affecting investors. A review of this record indicates that state securities regulators have often been the crucial first responders. From the research analyst cases to the mutual fund market-timing scandals, the states have often led the way to ensuring that investors are adequately protected. As will be set forth in detail below, on the seminal enforcement issues over the last ten years, time and time again, the states have been at the forefront. These examples illustrate how the complementary regulatory oversight inherent in our federalist system has helped maintain worldwide confidence in the United States markets as a secure place to invest, where investments are protected by rigorously enforced laws.

1 Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 Wake Forest L. Rev. 879, 900 (2006) (quoting Robert Schapiro, *Toward a Theory of Interactive Federalism*, 91 Iowa L. Rev. 243, 289-90 (2005)).

The following examples, starting with the most recent and going back in time, illustrate the states' central role in securities enforcement over the last 10 years.

A. Auction Rate Securities

The states have been at the forefront of the auction rate securities enforcement actions, which has resulted in over $50 billion worth of customer refunds thus far. Specifically, in June of this year, the Massachusetts Securities Division filed an administrative complaint against UBS Securities, LLC and UBS Financial Services, Inc. in connection with their marketing and sales of auction rate securities.[2] The investigation exposed a profound conflict of interest between UBS and its customers and the devastating effect that this conflict had on those customers. It exposed how UBS was, unbeknownst to its customers, propping up its auction rate market and manipulating the interest rates at which auctions cleared. It also exposed how, as the auction markets became more risky, UBS increased its efforts to offload auction rate risk from its own balance sheet onto the accounts of its customers. These customers included many retail customers who did not have a clear understanding of these complex instruments and who relied on their financial advisors' representations that these instruments were "cash equivalents" and as safe as CDs or money market funds. Many of these investors were seeking to save money in a cash-like instrument in order to be able to use it for a down payment for a house, college for their children or retirement expenses. When the large underwriters of auction rate securities ceased supporting their auction programs, these customers were stuck holding illiquid instruments that were anything but "cash equivalent".

The Massachusetts action against UBS was followed by similar actions filed by securities regulators in New York and Texas. These states, coordinated through the North American Securities Administrators Association ("NASAA"), and with the cooperation of the United States Securities and Exchange Commission (the "SEC"), negotiated an investor refund exceeding $19 billion.

In July of this year, the Massachusetts Securities Division filed an administrative complaint against Merrill Lynch.[3] The complaint charged the firm with implementing a sales and marketing scheme which significantly misstated the nature of auction rate securities and the overall stability of the auction market. The complaint also focused on the extent to which Merrill Lynch co-opted its supposedly independent research department to assist in sales efforts geared towards reducing its inventory of auction rate securities. Massachusetts, with the assistance of NASAA and the cooperation of the SEC, negotiated an investor refund in excess of $10 billion.

In addition, NASAA formed an auction rate task force. The mission of the task force was to coordinate investigations, enforcement actions and settlements, and to facilitate cooperation with federal regulators. For example, Texas was the lead state on the Citigroup investigation, Missouri was the lead state on the Wachovia investigation and Massachusetts was the lead state on the Bank of America, UBS and Merrill Lynch investigations. The lead states served as the liaison between the targets of the investigation and the task force, resulting in a streamlined and efficient process of negotiating settlements, which yielded customer refunds in the tens of billions of dollars. The *Wall Street Journal* referred to these settlements as "potentially the largest mass bailout of American individual investors ever".[4]

The SEC had looked into underwriting and sales practices of auction rate securities in 2006, and, while

2 *In the Matter of UBS Securities, LLC and UBS Financial Services, Inc.*, Docket No. 2008-0045 (Mass. Sec. Div. 2008).
3 *In the Matter of Merrill, Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2008-0058 (Mass. Sec. Div. 2008).
4 Liz Rappaport and Randall Smith, *UBS to Pay $19 Billion as Auction Mess Hits Wall Street,* Wall Street Journal, August 9-10, 2008, at A1.

it did discover and attempt to remedy certain manipulative practices, did not uncover the fundamental conflicts of interest that pervaded the auction rate market.[5]

B. Collateralized Debt Obligations and Auction Rate Securities Sold to Municipalities

When municipalities find themselves in the unfortunate situation of having been sold exotic and unsuitable financial products, they typically turn to their local state securities regulators for relief. In February 2008, the Massachusetts Securities Division filed an administrative complaint against Merrill Lynch[6] alleging fraud in connection with its sale of Collateralized Debt Obligations ("CDOs") to the City of Springfield, Massachusetts. CDOs are esoteric financial instruments collateralized by certain assets, such as pools of subprime mortgage loans. In certain CDOs, the collateral consisted of pieces of other CDOs, which can magnify the risk exponentially. The city's goal had been to invest in safe, cash-like investments. However, Merrill's representatives invested much of the city's money into three highly-risky CDOs, including CDOs collateralized by other CDOs.

Shortly after the sale of these CDOs to the city, and despite their triple-A rating, the market for them began to dry up and their market value began to plummet. The estimated market value of one of the CDOs dropped, in a couple of months, to 5 percent of the purchase price. Merrill initially disclaimed responsibility for these sales, but after the Massachusetts Securities Division and the Massachusetts Attorney General began to investigate, it agreed to buy these instruments back. Federal securities regulators were not involved in this action.

Similarly, the Massachusetts Securities Division and the Massachusetts Attorney General's Office have been instrumental in getting state and local governmental and quasi-governmental entities restitution for the auction rate securities that had been improperly sold to them.[7]

C. Fraudulent and Deceptive Senior Designations

In September 2002, the Massachusetts Securities Division initiated an administrative action against Tyrone Clark and his company Brokers Choice of America[8], alleging, among other things, widespread dissemination for use by financial advisors of the "Certified Elder Planning Specialist" designations. The Division alleged that the designation was fraudulent and misleading and was ultimately able to ban its use in Massachusetts. Other states subsequently brought their own actions against these respondents.

In November 2005, the Massachusetts Securities Division filed an administrative action against Investors Capital Corp., alleging that its agents were using spurious professional designations to gain the trust of senior citizens and engaged abusive sales of equity-indexed annuities.[9] These annuities often had lengthy lock-up periods and large surrender fees which rendered them unsuitable for the senior citizens to whom they were sold. The Division was able to obtain rescission and restitution for all clients in Massachusetts

5 *In the Matter of Bear, Stearns & Co. Inc. et al.*, Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934, SEC Release Nos. 8684 and 53888 (2006); Michael McDonald and David Scheer, "SEC `Missed Opportunity' to Save Auction-Rate Buyers", Bloomberg.com (September 8, 2008), www.bloomberg.com/apps/news?pid=20670001&refer=us&sid=avSsVJeVq02k.

6 *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated, et al.*, Docket No. 2008-0001 (Mass. Sec. Div. 2008).

7 *See* John Hechinger, *UBS to Pay $35 Million to Massachusetts Cities,* Wall Street Journal, May 9, 2008 (describing how UBS agreed, in a settlement agreement with the Massachusetts Attorney General, to pay $35 million to the cities and towns in Massachusetts to repurchase the auction rate securities it had sold to them).

8 *In the Matter of Tyrone M. Clark, Brokers Choice of America, Inc. et al.,* Docket No. E-2002-47 (Mass Sec. Div. 2002).

9 *In the Matter of Investors Capital Corp.,* Docket No. E-2005-0190 (Mass. Sec. Div. 2006).

over the age of 75. Subsequent to the *Investors Capital Corp.* case, and other lawsuits challenging the suitability and widespread sales practices with respect to equity-indexed annuities, the SEC has proposed that on a going forward basis, equity indexed annuities should be treated as securities and should be subject to SEC regulation.[10]

Spurious senior designations have proven to be a challenging problem, and have resulted in a number of additional enforcement actions by the Massachusetts Securities Division and other states. One enforcement action, in particular, against Michael DelMonico and Workman Securities Corp.[11] drew national attention to the use of senior designations that improperly imply an expertise in senior affairs.[12]

The use of spurious senior-specific designations became so widespread that the Massachusetts Securities Division promulgated a rule requiring accreditation of senior advisers' credentials.[13] NASAA then followed with its own proposed rule on senior designations.[14] That rule has been adopted by a number of states and has been a centerpiece of potential federal legislation geared towards limiting senior abuse.[15]

D. Fee-Laden Variable Annuities

In July 2005, the Massachusetts Securities Division sanctioned the brokerage unit of Citizens Bank for impermissibly blurring its banking and investment businesses in a way that confused customers as to the differences between insured bank products such as certificates of deposit ("CDs") and uninsured investment securities such as variable annuities.[16] The action alleged that the bank and its affiliated broker-dealer collaborated to assure a steady stream of business would flow from bank deposits into brokerage accounts. The complaint alleged that these "tangled business practices…misled Massachusetts investors as to the risks associated with investing in non-bank products."[17]

The practice unfairly targeted the bank's senior customers, who were often solicited to buy variable annuities products after receiving reminders from the bank that their CDs with the bank were coming due. Upon visiting the branch, the senior customers were directed to the broker-dealer section and were regularly told that the variable annuities were just like CDs, but with better interest rates. Most senior customers were not adequately informed that their money would be subject to market risk or that efforts to withdraw the money early would result in steep surrender charges. Several senior customers informed the Securities Division that they were not even aware they were dealing with any other entity except the bank. The settlement Citizens entered into with the Division provided for restitution for senior citizens 75 years old or older in every state in which the bank had operated. Similarly, Bank of America agreed to a settlement of the Division's investigation of its variable annuity sales practices that resulted in restitution for senior citizens nationwide 78 years old or older. Had it not been for the functional expertise of the Securities Division, and its attendant focus on investor protection, these egregious abuses occurring on bank premises may have gone undetected.

10 Indexed Annuities and Certain Other Insurance Contracts, Release No. 8933 (June 25, 2008) (73 FR 37752).
11 *In the Matter of Workman Securities Corp., Paul Maxa, Robert Vollbrecht and Michael Mark Delmonico*, E-2007-0020 (Mass Sec. Div. 2007).
12 *See* Charles Duhigg, *For Elderly Investors, Instant Experts Abound*, New York Times, July 8, 2007, at A1.
13 950 CMR 12.204(2)(i) & 950 CMR 12.205(9)(c)(15).
14 NASAA, Model Rule on Senior Specific Professional Designations (adopted March 20, 2007).
15 "To Protect Older Americans From Misleading and Fraudulent Marketing Practices, With the Goal of Increasing Retirement Security", S. 2794, 110th Cong. (2008).
16 *See In the Matter of Citizens Inv. Servs. Corp.*, Docket No. E-2004-0050 (Mass. Sec. Div. 2005).
17 *Id*.

E. Market Timing/Late Trading

The mutual fund market timing and late trading abuses were similarly uncovered and prosecuted by state securities regulators. In September 2003, New York Attorney General Elliot Spitzer brought an action against the hedge fund Canary Capital Partners, alleging that the fund used certain prohibited market timing and late trading tactics to game certain mutual funds. One of Canary's schemes involved various Nations Funds, advised by Banc of America Capital Management, a unit of Bank of America. Canary bought fund shares at market close, but at prices that hadn't yet factored in underlying stock moves from the day's activity. Fund purchases made after market close are supposed to reflect that day's activity and, therefore, are priced at the next day's net asset value. By buying at old prices, and selling the next day or later, Canary locked in a guaranteed gain. The funds' management company was completely aware of the purchases and permitted them, despite those purchases being explicitly prohibited in the funds' prospectuses.[18] In the settlement with the New York Attorney General's office and the SEC, Bank of America settled for $675 million in fines and restitution to investors and Canary settled by paying $40 million in fines and restitution.

In October 2003, the Massachusetts Securities Division brought an administrative complaint against Putnam Investment Management, alleging that Putnam had allowed certain fund investors to engage in improper market timing.[19] Putnam was an investment advisor that offered and sold proprietary mutual funds to institutions and individuals. The disclosures in the funds' prospectuses indicated that market timing would not be allowed. This market timing policy was to protect long-term investors from the negative effects of excessive trading, including dilution of share value, negative tax consequences, increased transaction costs and loss of fund investment opportunities. Unknown to long-term shareholders, and in direct contradiction of the prospectus disclosure, Putnam allowed certain clients to engage in market timing activity. In a settlement entered into in August 2004 with the Massachusetts Securities Division, as well as with the SEC, Putnam admitted to the Division's finding of facts and agreed to pay a fine of $50 million, and provided restitution to investors nationwide in an amount that exceeded $150 million. The Massachusetts Securities Division also filed a similar market timing case against Prudential Securities, alleging market timing and late trading by certain prudential employees on behalf of their hedge fund clients, which resulted in a settlement with the Division, the New Jersey Securities Commission, the New York Attorney General's Office, the New York Stock Exchange, the U.S. Attorney's Office, the National Association of Securities Dealers and the SEC providing for restitution to investors, and civil and criminal penalties in excess of $600 million.[20]

The Government Accountability Office ("GAO") has researched and reported on how the federal regulators failed to address the widespread market timing and late-trading abuses in a timely manner.[21] The GAO report explicitly recognized that it was the states that first discovered these violations.[22]

18 *See* Ari Weinberg, *Eliot Spitzer Finds His Canary*, Forbes.com, September 3, 2003, www.forbes.com/2003/09/03/cx_aw_0903spitzer_print.html.

19 *In the Matter of Putnam Investment Management, Inc., et al*, Docket No. 2003-061 (Mass. Sec. Div. 2003).

20 *In the Matter of Prudential Securities, Inc.*, Docket No. 2003-0075 (Mass. Sec. Div. 2003).

21 U.S. GAO, *Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage*, Report No. GAO-05-313 (2005).

22 *Id.* at 18-19 ("In early 2003, an insider at a Boston-based fund company provided information and documentation to SEC's Boston district office suggesting that company management failed to control widespread abusive market timing by fund customers….Subsequently, the insider turned the information over to the Massachusetts Securities Division, which settled state charges against the fund company related to the insider's allegations….If the district office had pursued this information in early 2003, the potential exists that examiners would have identified other weaknesses, such as the market timing abuses by company insiders sooner than they did in late 2003.").

F. Revenue Sharing—"Shelf Space" Agreements

In July 2003, the Massachusetts Securities Division filed an administrative complaint against Morgan Stanley to address conflicts of interest related to, among others, the firm's practice of entering into revenue sharing agreements with mutual fund companies.[23] In these so called "shelf space" agreements, mutual fund companies offered incentives, including actual cash compensation, to broker-dealers and their staff, including financial advisors, in return for increased access to the firm's staff – to the exclusion of other fund companies. The Division alleged that these relationships created fundamental conflicts of interest between what was best for investors on one hand and what is best for the financial advisors, broker-dealers and fund companies on the other. In the action, the Division stressed that these conflicts of interest were so unmanageable and so fraught with potential abuse that they could not be managed regardless of whether the relationship was disclosed to the investor. The significant attention directed by the states to the conflicts of interest created by these cozy revenue sharing agreements between mutual fund companies and broker-dealers contributed to the SEC subsequently banning mutual fund companies from entering into revenue sharing agreements when broker-dealers are compensated in part by directing brokerage transactions to that broker for selling the fund's shares.[24]

G. Tainted Stock Ratings and Research Analysts

The states were also in the lead in the tainted research analyst cases. The New York Attorney General's Office brought the first tainted stock rating case in 2001 when it sued Merrill Lynch. Attorney General Spitzer had alleged that Merrill Lynch's securities research analysts who rated stocks were improperly influenced by the firm's investment banking arm in their evaluation of companies with which Merrill did investment banking business.[25] For example, due to these conflicts of interests, certain stocks were rated "buy" or "neutral" despite internal analyst communications suggesting that they, in fact, held a much lower evaluation of the value and prospects of those stocks. Under the settlement, Merrill agreed, among other things, to prohibit investment banking input into analysts' compensation and to create a new investment review committee responsible for approving all research recommendations with strict standards and independence from investment banking.[26] Similarly, in October 2002, the Massachusetts Securities Division charged the investment banking firm Credit Suisse First Boston Corporation ("CSFB") with misleading investors with respect to the undue influence its investment banking division exerted over its supposedly-independent research analysts.[27] The complaint highlighted the need to establish a bright line between the investment banker and the research analyst.

Other state securities regulators brought additional research analyst cases. NASAA formed a working group, and under its auspices each lead state investigated an investment bank. Through this working group, the states shared research, investigatory techniques, pooled resources and structured a global settlement along with the SEC, the New York Stock Exchange and the National Association of Securities Dealers. The top investment firms (including CSFB) settled enforcement actions involving conflicts of

23 *In the Matter of Morgan Stanley DW, Inc.*, Docket No. E-2003-0053 (Mass. Sec. Div. 2003).
24 *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, S.E.C. Release No. IC-26591 (September 2, 2004).
25 *See* Affidavit in Support of an Order Pursuant to General Business Law Section 354, *In the Matter of Merrill Lynch & Co. et al*. (April 2002), www.oag.state.ny.us/media_center/2002/apr/MerrillL.pdf.
26 "Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices," www.oag.state.ny.us/media_center/2002/may/may21a_02.html.
27 *In the Matter of Credit Suisse First Boston Corporation*, Docket No. E-2002-41 (Mass. Sec. Div. 2002).

interest between research and investment banking. The firms paid a total of $875 million in penalties and disgorgement, approximately $432.5 million to fund independent research, and $80 million for investor education in a global settlement.[28]

H. Day Trading

In 1998 and 1999 the Massachusetts Securities Division brought six day trading cases, which generated national attention regarding abuses within the day trading industry.[29] The cases addressed issues that included deceptive marketing, suitability, encouragement of unregistered investment advisory activity, abuse of discretionary accounts, promotion of lending activity outside the normal margin arrangement, including lending by third parties to customers and lending among customers, the use of margin beyond the parameters normally applicable to customers, the financial exposure of clearing brokers, the applicability of SIPC coverage, recordkeeping failures, failures of supervision and market manipulation effected by or on behalf of day trading firms.

In October 1998, the NASAA Day Trading Project Group was formed, primarily to assist state securities regulators in understanding and responding to the issues posed by the day trading industry. The Group issued a report on day trading abuses in August 1999. In March 1999, Representatives from the SEC and NASD Regulation met with the Massachusetts Securities Division to discuss abuses by the day trading industry. The meeting was initiated because of the mutual interest of the state and federal regulators in understanding and addressing the many emerging issues surrounding the day trading industry. The meeting resulted in the sharing of information among regulators which led to greater understanding of the regulatory issues to be addressed. Cooperation among the regulators facilitated further enforcement efforts by the SEC, NASD and the states. Cooperation among the regulators also was instrumental in the creation and approval by the SEC of new requirements, on July 10, 2000, that required firms to ensure that day trading strategies are appropriate for their customers and that firms provide special risk disclosure statements prior to account openings.

I. Summary

The above examples highlight the extent to which the states have been the primary protectors of savers, investors, retirees and other consumers of financial services over the last ten years. It is essential that this history inform any regulatory restructuring that occurs. The SEC has been at the forefront on many issues, including insider trading, market manipulation and options backdating, and has certainly provided needed relief to a wide range of investors. However, on the retail, consumer-facing, business-conduct issues that have arisen, as described above, the states have consistently been at the forefront of investor protection. [30]

28 *See SEC Fact Sheet on Global Analyst Research Settlements,* May 28, 2003, www.sec.gov/news/speech/factsheet.htm.

29 See *In the Matter of Block Trading, Inc., et al*., Docket No 98-58 (Mass. Sec. Div. 1998); *In re Bright Trading, Inc, et al.* , Docket No. 98-70 (Mass. Sec. Div. 1998); *In re All-Tech Investment Group, Inc., et al.*, Docket No. 98-77 (Mass. Sec. Div. 1998); *In re On-Line Investment Services, Inc., et al.*, Docket No. 99-1 (Mass. Sec. Div. 1999); *In re TCI Corporation, et al.*, Docket No. 99-9 (Mass. Sec. Div. 1999); *In re Landmark Securities, Inc., et al.*, Docket No. 99-29 (Mass. Sec. Div. 1999).

30 Susan Antilla, *Bankers Would Love to Kneecap State Regulators*, Bloomberg.com, November 14, 2008, www.bloomberg.com/apps/news?pid=email_en&refer==home&sid==aroo8dC2qwt8.

III. Preservation of State Enforcement Authority is Needed to Counteract Financial Consolidation that has Occurred and to Serve as a Counterbalance to Federal Regulatory Consolidation That is Likely to Occur

A. State Securities Regulators Have Protected Investors from the Effects of the Consolidation That Has Occurred Within the Financial Services Industry Over the Last Ten Years

After the stock market crash of 1929 and during the Great Depression, in which approximately 11,000 banks failed, Congress passed the Banking Act of 1933, otherwise known as the Glass-Steagall Act.[31] One of the central purposes of the Glass-Steagall Act was to separate commercial banking from investment banking. The primary reasons for creating this separation were (1) to protect banks from speculative activities that caused so many bank failures, and (2) to protect consumers from conflicts of interest that arose from the affiliation of commercial banks, investment banks and insurance companies.[32]

Traditionally, bankers guarded your money and paid nominal interest. Brokers invested your money in more speculative instruments that could lose value. The drafters of Glass Steagall worried that if bankers had incentives to sell certain products to their customers that had been underwritten by the bank's underwriting arm, those incentives could subvert the principles of commercial honor and fair dealing that bankers and brokers are supposed to observe in their transactions with their customers. The United States Supreme Court, in the 1970 decision *Investment Company v. Camp*, discussed in detail the rationale underlying Glass-Steagall.[33] The Court reflected on the "subtle hazards" that arise when a commercial bank goes beyond the business of acting as a fiduciary and enters the investment banking business.[34] In the words of the court: "This course places new promotional and other pressures on the bank which in turn create new temptations."[35]

The separation of commercial and investment banking created by Glass Steagall existed for a number of decades, until it was steadily eroded by lobbying efforts in the 1980s and 1990s and finally repealed 1999 by the Gramm Leach Bliley Financial Modernization Act of 1999.[36] In addition to allowing banks and securities firms to affiliate, Gramm Leach Bliley opened the door for the merging of these industries with the insurance industry. Specifically, the Gramm Leach Bliley Act made changes to the Financial Company Holding Act of 1956 which allowed banks to affiliate with insurance companies. Gramm Leach Bliley paved the way for a consolidation of financial functions within the financial services industries, with the same entities now being able to offer insurance, securities and banking products.

The consolidation of the banking, securities and insurance industries has intensified many conflicts of interest in the banking and brokerage industries. The consumer-facing effects of the post-Gramm Leach

31 The Banking Act of 1933, Pub. L. No. 33-66, ch. 89, 48 Stat. 162 (1933).
32 *See* Richard M. Weber, Jr. , *Subtle Hazards*, 124 Banking L. J. 324 (2007).
33 *Investment Company Institute v. Camp*, 401 U.S. 617 (1971).
34 *Id.* at 630.
35 *Id.* at 630-31. During the Glass-Steagall subcommittee hearings, Senator Robert Bulkley from Ohio addressed this risk by stating:

> Obviously the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of his depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit. (75 Cong. Rec. 9912)

36 Public Law 106-102, 113 Stat. 1338, enacted November 12, 1999.

Bliley consolidation have not been effectively addressed on the federal level, and it has primarily been the states that have protected investors from the effects of these conflicts. For example, as discussed in the section II(A) above, brokers at financial conglomerates such as Citigroup, UBS and Bank of America encouraged their customers to place the cash portion of their savings into so-called "cash-equivalent" products that the underwriting arm of the respective firm had underwritten. These products were called auction rate securities, which were basically long-term debt or preferred shares of closed end funds that were treated like short term debt because they supposedly could be sold in an auction held every 7 or 28 days. Customers were unaware that their financial advisor had been given special incentives to move product that the investment banking side of the firm had underwritten. Financial advisors' commissions were based directly on the quantity of product sold (not on the suitability of the product to the customer). When the $330 billion dollar market for auction rate securities crashed on February 12, 2008, the consumers were stuck holding instruments that were anything but "cash equivalent".[37] This is an example of consolidated financial conglomerates offering their depository clients securities products that the firm had underwritten. The brokers were subject to the exact types of conflicts of interest that the drafters of the Glass Steagall Act were concerned with, but which were entirely undisclosed to the customers. Federal regulators were slow to move to correct the problem, and became fully engaged only after states initiated enforcement actions.[38]

Another example can be found in the sales (as described in Section II(C) above) of unsuitable equity indexed annuities to senior citizens. Equity-indexed annuities until recently were considered not to be securities even though their returns are directly tied to the performance of the stock market. Registered representatives of securities broker-dealers used the imprimatur and brand of their securities firm to gain legitimacy with their customers in order to sell high commission equity-indexed annuities to senior citizens, which annuities typically had surrender fees in excess of twelve percent of the principal amount invested and lock up-periods ranging from nine to fifteen years. This was an example of a recently-engineered hybrid insurance/security product sold across traditional industry lines that simply fell through the federal regulatory cracks. It was state regulators who fielded the calls from distraught customers and who uncovered and prosecuted this practice. Federal regulators got involved (as described in Section II(C) above) only after the states had raised these sales as an enforcement issue.

Yet another example lies in the sales by Bank of America and Citizens Bank (described in Section II(D) above of variable annuities (which are clearly securities) being sold at banks, with the customer not knowing that their banker was incentivized to sell securities products being provided by the firm's securities arm. The cross-selling of these products across industry lines, with customers thinking they were obtaining banking services in a bank when they were in fact being pitched exotic securities products, was discovered and prosecuted by state securities regulators.

In each of these instances, the post-Gramm Leach Bliley financial consolidation has allowed for the marketing and sale of products within the same financial conglomerate but across traditional industry lines. In each instance described above, federal securities regulators have been slow in detecting or correcting the problem. The states have been the "first responders" who have fielded calls from investors and provided a strong regulatory response. It is difficult to speculate why federal regulatory efforts over

37 *See* Note 2, *supra.*

38 *See* Michael McDonald and David Scheer, *SEC "Missed Opportunity" to Save Auction-Rate Buyers," Bloomerg.com (September 8, 2008), w*ww.bloomberg.com/apps/news?pid=20670001&refer=us&sid=avSsVJeVq02k

the last ten years have not kept pace with financial innovation and consolidation that has occurred, and such speculation is outside of the scope of this paper. However, irrespective of the reasons, the lesson is clear: the "fail-safe mechanism" provided by state securities regulators to protect investors has proven itself essential not only to investor protection, but to the smooth functioning of our financial markets.

B. Any Federal Regulatory Consolidation Should be Counterbalanced by an Affirmation of the States' Securities Enforcement Powers

In the recent Emergency Economic Stabilization Act of 2008,[39] Congress explicitly authorized a working group to make recommendations to modernize regulation of our financial regulatory system. Specifically, the Act established a Congressional Oversight Panel and charged it with submitting a special report on regulatory reform. This panel's mandate includes:

> analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the rationale underlying such recommendation, and whether there are any gaps in existing consumer protections.[40]

It is widely expected that the consolidation that has occurred in the financial services industry will be met with some sort of regulatory consolidation on the federal level. Many commentators have suggested that our "functional" regulatory system, where the SEC regulates securities, the U.S. Commodity Futures Trading Commission regulates futures, the U.S. Federal Reserve regulates certain banks and state insurance regulators regulate insurance is outmoded, and has allowed certain products and practices to fall through the cracks in a manner that has harmed savers and investors.[41] There has been much discussion recently of consolidating our functional federal regulatory system into a system where there is an integrated super-regulator which regulates across securities, insurance, and banking lines. Great Britain moved to such an integrated approach when it adopted its Financial Services and Markets Act of 2000, which created Great Britain's Financial Services Authority (the "FSA"). Similarly, there has also been talk of moving towards a tripartite model of regulation, under which there would be three centralized regulators, a market stability regulator, a prudential financial regulator and a business conduct regulator.[42]

It is difficult to imagine that such a consolidation at the federal level, whatever form it takes, will not be deregulatory in nature. There will likely be fewer cops on the beat, a greater possibility that those fewer regulators will be subject to so-called "regulatory capture",[43] and less regulatory competition among regulatory entities, none of which would bode well for consumers of financial services. There is also a concern that a large, centralized bureaucracy would be unable to rapidly and effectively respond to consumer concerns.[44]

39 Emergency Economic Stabilization Act of 2008, Public Law 110-343, 122 Stat. 3765, enacted October 3, 2008.

40 *Id.* § 125(b)(2).

41 *See, e.g.,* Heidi Schooner and Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 Tex. Int'l L. J. 317 (2003).

42 U.S. Department of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, at p. 143 (March 2008).

43 One definition of "regulatory capture is as follows: "a regulated industry has a far larger stake in regulatory decisions than any other group in society. As a result, regulated companies spend lavishly on lobbyists and lawyers and, over time, turn the regulatory process to their advantage." Timothy B. Lee, *Entangling the Web,* The New York Times, August 3, 2006.

44 *See* Jose de Luna Martinez & Thomas A. Rose, *International Survey of Integrated Financial Sector Supervision*, The World Bank Policy Research Working Paper 3096, at p. 2 (July 2003).

Any such deregulatory move would need to be counterbalanced by a reaffirmation of the states' central role in securities enforcement. This approach would allow the economy to benefit from any efficiencies that might accrue from a regulatory consolidation on the federal level, yet also to continue to benefit from the increased confidence in our markets that has accrued due to the comfort that the United States' markets are being adequately policed. It will also allow savers, investors and other consumers of financial services to continue to benefit from the regulatory and enforcement protections that state regulators have provided them for nearly a century.

There has also been a lot of discussion of moving away from a regulatory system that depends on prescriptive rules and moving towards a principles-based system.[45] Britain's FSA has embraced a principles-based approach and is attempting to minimize its rulebook, in favor of broad principles that can be implemented through proactive dialogue with regulated entities. Principles-based regulation focuses on constant dialogue between the regulators and the firm, and self-policing, to make sure that broad principles promulgated by the regulators are adhered to. The regulator also provides interpretive guidance as to how to apply the rules to a given situation and monitors the firms to make sure that they abide by that guidance. Ideally, more time would be spent on dialogue and monitoring and, as a result, less time on enforcement.

Thus far, the FSA's principles-based approach has proven inadequate for the protection of retail investors and savers.[46] The FSA's policy of promoting business in the U.K. financial markets, through light regulation, is widely attributed to being a cause of the FSA's lack of effectiveness.[47] The FSA has been involved in a series of high profile failures to adequately oversee and regulate financial industries. For example, the FSA has been widely criticized for its ineffective pursuit of abuses in the sales of split-capital investment trusts. Split-capital investment trusts are a type of closed-end mutual fund with multiple share classes. These trusts did not properly disclose some their more speculative features, particularly their use of leverage. These trusts were sold to large numbers of less sophisticated retail investors. After a long investigation, the FSA initially indicated that it was seeking £350M in restitution from a brokerage charged with selling these products. However, this restitution was unexpectedly reduced to just £194M.[48] In 2007, the FSA suddenly abandoned its comprehensive investigation into split-capital investment trusts and the selling of those products without taking any remedial action against several firms involved in the scandal.[49]

Again, it is difficult to imagine that a principles-based regulatory regime would be anything but deregulatory in nature, as one of its central tenets is industry self-policing and two of its central goals are limiting the number of rules that have to be enforced and limiting enforcement activities. In order to ensure adequate protection of savers, investors and other consumers of financial services, any such deregulatory move would have to be counterbalanced by a reaffirmation of the states' central role in securities enforcement.

45 *See, e.g.*, Interim Report of the Committee on Capital Markets Regulation, at pp. 63-65 (November 30, 2006).
46 Steve Goldstein, *FSA's Rock Failure is about Policy, not Just Practice*, Marketwatch, March 26, 2008, http://www.marketwatch.com/news/story/fsas-northern-rock-failure-about/story.aspx?guid=%7B50D14C35-A90B-4A81-B55B-BF8FB9530B40%7D.
47 Neil Shah, *Watchdog Bark May Lack Bite*, Wall Street Journal, July 24, 2008, at C2.
48 *Mud on Both Faces*, The Economist January 22, 2005.
49 Patrick Hosking, *FSA Ends Split-cap Scandal Investigation With no Scalps*, Times of London, May 22, 2007, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article1821459.ece.

IV. Limitations on State Regulatory Authority from Past Preemption Have Weakened Overall Regulatory Effectiveness and Market Transparency

The National Securities Markets Improvement Act of 1996 ("NSMIA")[50] preempted the states' ability to regulate federal covered securities. The most substantial preemption was in the areas of mutual funds and private offerings offered and sold under Rule 506 of SEC Regulation D.[51] In the aftermath of NSMIA, the states could only receive notice filings from these issuers.[52] The notice filing for a Regulation D offering is now a four-page SEC Form D, which includes only limited information about the issuer of the securities and about the persons offering and selling them.[53]

Prior to NSMIA, states could require that the offering documents for non-public transactions be filed with their securities agencies, and, when warranted, the agencies could issue regulatory comments on those offerings. Many states used their ability to issue regulatory comments to rein in aggressive tax shelter offerings and speculative oil and gas programs. State review of these offerings provided important preventative benefits, because the simple requirement to file these offerings with a state regulator served as a deterrent against some of the most aggressive and fraudulent offerings. Now that the issuers in Rule 506 offerings do not file offering materials with the states or with any other regulators, the states and other regulators have no meaningful information about these issuers and the purposes of these offerings.

Hedge funds provide an example of the regulatory blind spot that NSMIA has created. Most hedge funds are sold pursuant to Rule 506 of Regulation D. Because these offerings are federal covered securities, the states cannot regulate them or even ask for their offering documents. As a result, regulators do not see the offering materials for hedge funds when those securities are being offered and sold and do not become apprised of basic facts about these issuers such as their business and financing plans.

Unfortunately, regulators often learn about hedge funds and other non-public issuers only after there are complaints about fraud and the offering has become a matter for securities enforcement. In light of the turmoil that we have seen in the financial markets, and the fact that state regulatory oversight has already been weakened substantially, it would be detrimental for investors and the economy to further limit the authority of state regulators.

V. Conclusion

In light of the demonstrated record of performance above, in which the states have consistently been at the forefront of investor protection, it would be extremely damaging to investors, savers and other consumers of financial services to further preempt state enforcement authority. Any consolidation of federal regulatory authority, or any move towards a princples-based regulatory system, needs to be counterbalanced by an express recognition and affirmation of the states' invaluable role in securities enforcement.

It would be beneficial, in any large-scale regulatory restructuring, to encourage enhanced cooperation

50 National Securities Markets Improvement Act of 1996, Public Law 104-290, 110 Stat. 3416, enacted October 11, 1996.
51 See, Section 18(b) of the Securities Act of 1933, 15 USC 77r(b).
52 See, Section 18(b)(4)(D) of the Securities Act of 1933, 15 USC 77r(b)(4)(D).
53 SEC Form D, http://www.sec.gov/about/forms/formd.pdf.

between federal and state securities enforcement authorities. One commentator has discussed the idea of an "interactive" conception of the federal-state securities regulation, and has suggested that "competition, cooperation, and coordination among state and federal regulators are by-products of a system of concurrent authority that accrues to the public benefit".[54] Such increased cooperation, information sharing, and coordination among federal agencies and state agencies would likely increase the consistency of investor protection efforts and lessen the likelihood of certain products and business conduct practices falling through the regulatory cracks. However, in order to protect the states' demonstrated and valuable role as the "fail safe" protector of savers and investors, and to protect our nation's history of regulatory competition which has increased regulatory vigilance, such cooperation must be promoted in a manner that does not compromise the independence and authority of state securities regulators.

54 *See* Jones, *supra*, note 1, at 899.