**Testimony before the House Financial Services Committee**
**William F. Galvin, Secretary of the Commonwealth Of Massachusetts**
**March 20, 2009**

Chairman Frank, Ranking Member Bacchus, members of the Committee, I am pleased to have this opportunity to testify on the crucial role of state securities regulators in financial regulation and investor protection.

As Secretary of the Commonwealth of Massachusetts, I am an elected constitutional officer, and as head of the Massachusetts Securities Division, I am the chief securities regulator for Massachusetts.

The Securities Division regulates to protect investors and promote confidence in the securities markets. The Division carries out these goals through a vigorous program of investigations and enforcement.

In the United States, securities are regulated by the Securities and Exchange Commission and by states securities agencies in a system of complementary regulation. This is consistent with our federal system. Concurrent state and federal regulation over securities allows regulators at different levels of government to work together, and it permits each regulator to serve as a backstop in case the other regulator is not acting to protect investors.

## THE STATES HAVE A STRONG RECORD OF EFFECTIVE SECURITIES REGULATION

Massachusetts, along with other states, has been at the forefront in bringing enforcement actions to protect investors. These include:

- Actions against brokerages using bogus stock analyst reports to entice customers to buy low-value stocks and debt securities;[1]

[1] *In the Matter of Credit Suisse First Boston Corporation*, Docket No. E-2002-41 (Mass.

- Cases against mutual fund companies that illegally facilitated "market timing" trades;[2]

- Actions against abusive sales of variable annuities;[3]

- Actions against the use of spurious "senior credentials" to sell inappropriate investments to older investors;[4]

- Actions against unsuitable sales and fraudulent practices in the sale of auction-rate securities to retail and municipal investors;[5]

- Investigations and actions against pyramid schemes, including the Madoff scheme, and their feeder-funds; and

- Several hedge fund cases.[6]

The Massachusetts Securities Division has acted promptly and decisively to protect the interests of investors, particularly retail investors. While the Division does not have criminal enforcement powers, we use civil enforcement to implement strong and effective remedies against violators.

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Sec. Div. 2002). *In the Matter of Merrill, Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2008-0058 (Mass. Sec. Div. 2008). The *Merrill Lynch* matter involved the use of research reports to inappropriately misstate the nature of auction rate securities and the overall stability of the auction market. Massachusetts, with the assistance of the North American Securities Administrators Association and the SEC, negotiated a refund to investors in excess of $10 billion.

[2] *In the Matter of Putnam Investment Management, Inc., et al*, Docket No. 2003-061 (Mass. Sec. Div. 2003); *In the Matter of Prudential Securities, Inc.*, Docket No. 2003-0075 (Mass. Sec. Div. 2003).

[3] *In the Matter of Citizens Investment Services Corp.*, Docket No. E-2004-0050 (Mass. Sec. Div. 2005).

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

[5] *In the Matter of UBS Securities, LLC and UBS Financial Services, Inc.*, Docket No. 2008-0045 (Mass. Sec. Div. 2008) *In the Matter of Merrill, Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2008-0058 (Mass. Sec. Div. 2008).

[6] *See*, for example, *In the Matter of River Stream Fund & Michael Carroll Regan*, Docket No. E-2008-0034.

## Fines and Restitution

Massachusetts and other states have negotiated substantial refunds for investors and imposed significant fines against violators. Massachusetts was the lead state in three auction-rate securities cases that ended with settlements that will return $33.9 billion to investors. The states' combined efforts in these cases will bring back $61.3 billion, to date, to investors across the country.

The Securities Division also participated in cases that saw investors receive $10,697,004 in 2008. In fiscal year 2008 the Securities Division imposed fines of $4,776,323.

Other state settlements include:

- Over $50 billion in customer refunds, including over $19 billion paid by UBS Securities, LLC, in settlements with state and federal regulators of auction-rate securities cases ;[7]

- Over $150 million in restitution nationwide, and a fine of $50 million, paid by Putnam Investment Management in the settlement with state and federal regulators of a major case on market timing of mutual fund shares;[8]

- A global settlement by state and federal regulators of cases involving tainted stock ratings and research analysts. The firms involved paid a total of $875 million in penalties and disgorgement, over $432 million to fund independent research, and $80 million for investor education.[9]

## Other Sanctions

State enforcement powers go beyond monetary sanctions. The Securities Division has revoked the licenses of serious violators in order to drive them out of the

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[7] *In the Matter of UBS Securities LLC and UBS Financial Services, Inc.*, Docket No. 2008-0045 (Mass. Sec. Div. 2008)

[8] *In the Matter of Putnam Investment Management, Inc., et al.*, Docket No. E-2003-61 (Mass. Sec. Div. 2003).

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

securities business. When appropriate, we refer cases to local, state, and federal prosecutors.

Even in enforcement cases that have been settled, Massachusetts has, in appropriate instances, required financial firms admit to the facts alleged against them, instead of merely reciting that the firm neither admits nor denies the facts alleged. This prevents such firms from treating violations of law as simply business as usual.

## GIVE STATE REGULATORS THE TOOLS TO PROTECT INVESTORS

I ask this Committee and the Congress to give the states the tools we need to maintain and enhance our ability regulate effectively and protect investors.

### The Impact of NSMIA Preemption

The National Securities Markets Improvements Act of 1996 ("NSMIA")[10] removed state regulatory authority over mutual funds, most private offerings of securities, and over large investment advisers. However, the states retain enforcement jurisdiction over fraud in those areas.

### Restore Full Enforcement Authority over Federally Registered Investment Advisors

Since the adoption of NSMIA, jurisdiction over investment advisers has been split between the federal government and the states, with the SEC regulating large investment advisers and the states regulating the smaller advisers (which have less than $25 million to $30 million under management). As a consequence of this split in

[10] Public law 106-102, 113 Stat. 1338, enacted November 12, 1999.

jurisdiction, the states can only pursue federally registered advisers for fraud, and not for other violations of regulatory rules. I ask that the Congress restore the states' power to act against federally registered investment advisers for other types of violations, including for "dishonest and unethical business practices."

**Reverse Limitation of State Rescission Remedy Under the Federal Arbitration Act**

The state securities acts permit the states to impose a range of remedial sanctions against violators, including, civil fines, license suspensions, and requiring that violators make rescission (repayment) to investors for violations of law.[11] These sanctions give the states the tools they need to punish and deter violations, and to recover money for defrauded investors.

The rescission remedy is particularly important because it hits violators in the pocketbook, and it helps make investors whole. Unfortunately, several court decisions have held that the Federal Arbitration Act (the "FAA") preempts the states' ability to order rescission for securities law violations.[12] These cases hold that the rescission remedy is preempted under the FAA because arbitration is the sole mechanism for investors to recover their losses.[13]

We strongly dispute these decisions, which ignore the remedial and deterrent

[11] See, for example, Section 407A(a) of Mass. General Law, Chapter 110A, the Mass. Uniform Securities Act.

[12] See, *Olde Discount v. Tupman*, 1 F.3d 202 (3d Cir. 1993) In *Olde Discount*, the court enjoined the Delaware Securities Commissioner from seeking rescission for investors in an administrative case because the investors had agreed to seek such relief exclusively through arbitration; the court held that the state of Delaware was preempted even though it was not a party to the arbitration agreement between brokerage and its customers.

[13] Virtually every investor in the United States signs a customer agreement that requires the customer to take any dispute with the brokerage –including allegations of fraud –to securities industry arbitration, rather than to court.

purpose of state-ordered rescission. We urge Congress to amend the Federal Arbitration Act to clarify that it does not preempt the states from ordering securities law violators to make rescission to their victims.

**Make Broker-Dealer Firms Subject to Fiduciary Standards, Not Just Arm's-Length Dealing with Customers**

Under current law, broker-dealer firms deal with their customers on an arm's-length basis, subject to an obligation of fair dealing.[14] This means that customers cannot rely on their brokers to meet fiduciary obligations of loyalty, care, and competence. In contrast to brokers, investment advisers work solely for their customers, and have an acknowledged fiduciary duty to them.

Brokerages like to have this issue both ways --among other practices, they frequently give their salespeople the title "financial advisor." This term blurs the nature of the firm's relationship with its customer by making the broker appear to be an investment adviser. However, when a dispute arises between the customer and the broker, the brokerage will strongly assert that it does not work for the customer, but instead has only an arm's-length relationship with that customer.

The Securities Division has seen examples of brokerages dealing unfairly and improperly with customers. Unfortunately, we have also witnessed customers who recover little or nothing for their losses due to the pro-industry arbitration system, and due to the fact that brokers are not considered fiduciaries. This system must be changed. I urge the Committee and the Congress to require that brokerages be in a fiduciary relationship to their customers, at least with respect to individual retail customers.

[14] See, for example, FINRA Manual, IM-2310-2, Fair Dealing with Customers.

## PROBLEMS ON THE HORIZON

- With several large brokerages going bankrupt and industry-wide layoffs, many former agents of broker-dealer firms are likely to become affiliated with brokerages that have a decentralized structure. Such firms treat each office, which may be as small as one person, as a branch office of the firm. We have seen instances where the firm's office of supervisory jurisdiction is far from the branch offices, sometimes in a different state. Such brokerage firms have a history of inadequately supervising their selling persons, and they have a track record of sales practice violations. Any such change in the industry will require federal and state regulators to be vigilant about these firms.
- Layoffs in the securities industry may lead some brokers to act as unregistered securities salespeople, sometimes called investment "finders." Many fraudulent private offerings have involved finders. It has been suggested that the SEC should exempt finders from federal jurisdiction, and then leave the issue to the states. Such an approach would inappropriately saddle the states with this widespread problem. Instead, state and federal regulators should work together to police this area and assure that anyone acting as a broker is properly licensed.
- Layoffs in the securities industry may be accompanied by cuts in brokerage firms' compliance budgets. We are concerned that such cuts will lead to a lack of adequate oversight at financial firms.
- Many hedge funds are liquidating because their investment strategies did not work and because the advisors anticipate they will not receive an incentive share of fund profits for years to come. We can expect many of the people who ran and

advised the last generation of hedge funds to set up new funds and start again. Unless regulation of hedge funds is significantly improved, we can expect to see a replay of past problems, which include: high fees, a general lack of transparency, anonymity of the principals of the funds, and a disturbing level of trading and sales practice abuses. I ask the Committee and the Congress to take steps to make hedge funds more transparent and their activities more visible.

- American households now rely on mutual funds to help fund retirement costs. Because so many retail investors have their savings in mutual funds, I urge the Committee and the Congress to give mutual funds appropriate scrutiny. No topic or type of investment should be off the table as the Congress enacts regulatory reform and improvements to investor protection.

Thank you for this opportunity to testify on these important issues. I welcome your questions.