SUBJECT: Continuing and revising State Securities Board and its authority

COMMITTEE: Pensions and Investments — favorable, without amendment

VOTE: 5 ayes — Tillery, Woolley, Crownover, Salinas, Goodman

0 nays

4 absent — George, Rangel, Telford, Williams

WITNESSES: For — None

Against — None

On — Denise Voigt Crawford, State Securities Board

BACKGROUND: In 1957, the Legislature enacted The Securities Act (VACS art. 581-2) and created the State Securities Board, which was charged with registering those who sell securities and provide investment advice and enforcing the act. The agency is the sole regulator of securities dealers and investment advisers controlling assets of less than $25 million, a market valued at $40 billion.

The board currently is composed of three public members appointed by the governor to staggered six-year terms. The board elects its own chair and appoints a commissioner to administer the act and serve as chief administrative officer of the agency.

The board employs 81 full-time equivalents (FTEs) in five divisions (Securities Regulation, Dealer Registration, Enforcement, General Counsel, and Staff Services) among four field offices in addition to the Austin headquarters.

The agency's approximately $3.5 million budget is funded from general revenue. However, the board collects $136.5 million in additional revenues, mostly from a one tenth of 1 percent statutory fee charged on all securities that must register or file notices with the board to be sold in Texas. Other revenues come from the fees charged to securities dealers and investment advisers who register with the board.

In 1996, Congress enacted the National Securities Markets Improvement Act (NSMIA), which prohibited states from registering certain federally controlled securities such as mutual funds and exchange listed stocks and bonds, or from requiring investment advisers who control assets of more than $25 million to register with the state. Instead, the state only may subject these federally regulated advisers to notice filing requirements and bring enforcement actions against such advisers for fraudulent conduct.

The agency last underwent sunset review in 1989. It will be abolished September 1, 2001, unless continued by the Legislature.

DIGEST:

HB 2255 would continue the State Securities Board until September 1, 2013, and would amend The Securities Act in a number of ways.

Changes in the board. HB 2255 would increase the number of members on State Securities Board from three to five and direct the governor to appoint two new members as soon as possible after the effective date of the statute — one for a term to expire January 20, 2005, and a one for a term to expire January 20, 2007, in order to maintain staggered terms.

New categories of regulated persons/entities:
Investment Advisers. HB 2255 would make investment advisers a separate category from securities dealers, adding a definition of an investment adviser as someone who, for compensation:

- advises another with respect to either the value of a security or the decision to buy or sell a security; or
- as part of the person's regular business, issues analyses or reports concerning a security or adopts the analyses or reports of others;

It also would codify the exemptions in the board's rules for banks, the media, those who advise only concerning government securities or the securities of a government corporation, and other professionals such as attorneys, accountants, engineers, teachers, and geologists whose performance of investment advising services is wholly incidental to the practice of the person's profession.

The bill would maintain current applicability of the act to the new category of investment advisers. The bill also would make changes throughout the act

and to relevant provisions in the Education, Finance, and Transportation Codes to reflect and clarify the new distinction, including a provision that a person who must register in two categories under the Act only would have to pay one fee to do business in the state.

The bill would add definitions for a "registered investment adviser," i.e., one who has been issued a registration under the act, and an "investment adviser representative," i.e., generally someone employed by or authorized by an investment adviser to act for the adviser. It also would require a representative to be registered as the agent of the investment adviser and allow revocation of a representative's registration if they advise for an investment adviser other than the one with whom they are registered to represent. If an investment adviser's registration was revoked, it would revoke the registration of the representative.

Federal covered investment adviser. Additionally, the bill would direct the board to authorize federally regulated investment advisers and their representatives to do business in Texas without being subject to most of the bill's provisions. These advisers would have to submit to suit in Texas for claims related to their business here, to submit a notice filing with the commissioner appointing the commissioner as the investment adviser's agent for service of process, and to renew the filing yearly for an annual fee.

Corporations. The bill would expand the provisions for criminal liability beyond individuals to include a corporation or other entity for acts of the entity's agent, if the agent was:

- Acting on behalf of the entity and within the scope of the agent's office or employment; and
- The act was "authorized, requested, commanded, performed or recklessly tolerated" by a majority of the governing board or a high managerial agent acting for the entity or in the scope of the agent's employment.

A corporation would have an affirmative defense if the high managerial agent with supervisory responsibility for the subject matter of the offense used due diligence to prevent it.

New duties and authority:
Inspections. HB 2255 would clarify the commissioner's authority to inspect without notice a registered dealer or investment adviser for compliance with the act and the board's rules, including by entering the registrant's place of business, and examining and copying records. The bill also would require the registrant to cooperate with the inspection by providing access to its records, files, safe, office, and any other location where books and records pertinent to the inspection were located, and allowing copying of all files and records without charging the commissioner a fee for doing so.

All information obtained in an inspection and any notes, memos, reports, and other advice, analyses, opinions and recommendations of the Commissioner relating to the inspection would be confidential and not subject to public release except under court order or, in the discretion of the commissioner, to governmental or quasi-governmental authorities that the Board by rule approves, or to a receiver.

Cease and desist orders. HB 2255 would extend the commissioner's authority to issue a cease and desist order to include orders directed against someone who is acting as an adviser or representative in violation of the act, such as by not being registered. The bill also would extend the cease and desist authority to allow orders to cover fraudulent practices regarding security sales, instead of simply enjoining sales of a named security. Finally, the bill would add a provision specifically providing cease and desist authority against an adviser or representative who was engaging in or is likely to engage in fraud or a fraudulent practice.

The commissioner would be required to serve on the person to be enjoined a proposed order that stated the acts or practices to be enjoined and to hold a hearing on the proposed order within 30 days after notice was served to determine if the Commissioner should issue the cease and desist order. Orders would have either to require the adviser or representative immediately to cease and desist from their fraudulent conduct or to prohibit the unregistered or unauthorized person from acting as an adviser or representative in violation of the act.

Emergency cease and desist orders. The bill would authorize the commissioner to issue emergency cease and desist orders when there was

reason to believe that immediate and irreparable harm to the public was threatened by:

- a fraud or a fraudulent practice in the offer or sale of a security or the rendering of investment advice;
- an offer containing a statement that was materially misleading or otherwise likely to deceive the public; or
- a violation of the act or a board rule.

The bill would provide procedures for notifying the person subject to the order of its existence and the right to request a hearing. The bill would limit the time in which such a hearing could be requested to 31 days after notice of the order, after which the order would be final. Further, the bill would set rules for the hearing, including requiring the commissioner to hold the hearing within 10 days of the written request for it, placing the burden of justifying the order on the Commissioner, and requiring that the Commissioner determine whether to affirm, modify, or set aside the order after the hearing.

Revocation of registrations. The bill would amend the Act to permit the Commissioner to deny, revoke, or suspend an investment adviser's registration if the adviser employed an unregistered representative.

The bill would provide that an emergency order continues in effect until it is stayed by the commissioner and would permit the commissioner to impose conditions on granting such a stay. Further, as with regular cease and desist orders relating to the sale or offer of securities, the bill would make violation of an emergency cease and desist order the basis for civil liability, as well as a felony punishable by a fine not to exceed $5,000 and/or imprisonment for not more than two years.

Education. The bill would authorize the board to require continuing education of dealers, agents, investment advisers, and their representatives. It also would permit the Board to require a testing service to notify applicants of the results of the examination required for registration.

HB 2255 would amend the Securities Act to add a section directing the board to develop and implement by December 31, 2001, an investor education initiative as a collaborative effort with interested public and nonprofit entities. The investor education project would emphasize detection

and prevention of consumer fraud, and materials would be published in both English and Spanish. The board also could accept grants and donations from individuals not affiliated with the securities industry and from any nonprofit entities for use on the investor education initiative.

Civil Liability. The bill would specify the types of civil liability that could arise for investment advisers and representatives. First, advisers and representatives who violate the registration provisions or the provisions of a cease and desist order would be liable to purchasers for damages equaling the amount of consideration paid for the advice. Purchasers would have three years from the violation to sue.

Second, advisers or representatives who committed fraud or engaged in fraudulent practices in rendering their advice would be liable to purchasers for:

- any consideration paid for the advice, less any income received based upon the advice;
- any loss incurred by acting on the advice provided;
- interest from the date of the payment of the consideration; and
- court costs and attorneys fees that the court determines are equitable.

Suits for such frauds or fraudulent practices would have to be brought within five years of the violation, but no more than three years from when the purchaser knew or reasonably should have known of the violation. Finally, the bill would provide a defense if the purchaser knew the adviser's or representative's statement or omission was false or misleading, or if the adviser or representative did not know and could not reasonably the statement was untrue or the omission was misleading.

In regard to both types of civil suits above, the bill would impose joint and several liability upon:

- one who controls an investment adviser unless the control person proved that he or she did not know or could not have reasonably known of the facts giving rise to liability; and
- one who materially aids an investment adviser in a violation with the intent to deceive or defraud or with reckless disregard for the truth or for the law.

Miscellaneous. The bill would add standard sunset provisions governing membership of the board, conflict of interest, appointee qualifications, appointment of board members, grounds for removal of a board member, standards of conduct, training, policies that separate the functions of agency staff and the policymaking body, and complaints. It also would remove references to "salesmen" throughout the Act.

The bill would take effect September 1, 2001.

SUPPORTERS SAY:

The Securities Board is a valuable and well run agency that the Legislature should continue. The Sunset Advisory Commission found that the Board is effective in carrying out its mission of protecting consumers against securities fraud and recommended continuation of the agency.

The Securities Board should be expanded from a three-member board because the small size causes problems with members communicating amongst themselves. Because two members constitute a quorum, members cannot informally discuss Securities Board issues without violating the Open Meetings Act. Nor can the board form subcommittees for oversight purposes.

The bill's delineation between "investment advisers" and "dealers" is necessary because these are district professions, and including investment advisers under the definition of dealers makes it unclear which sections of the act are intended to apply to which profession. Furthermore, the bill would distinguish between "investment advisers" and "federal covered investment advisers," whom the bill specifically would exempt from registration under the Securities Act. It also would define separately "registered investment advisers." These distinctions would prevent the act from violating federal law restricting state regulation of federal covered investment advisers.

The bill would make valuable improvements to the board's enforcement authority. For instance, currently the Securities Act does not clearly authorize the board to conduct inspections. HB 2255 explicitly would grant this necessary authority to ensure compliance with the act and to prevent fraudulent practices. Forty-eight other states and the federal government have explicit inspection authority. Moreover, the bill would make it clear that information gained from inspections is confidential. The board treats it as

such now, but it has been challenged on that count, and the bill would such avoid legal challenges to its authority.

The bill also correctly would authorize the board and its commissioner to issue emergency cease and desist orders. Currently, it can take months to get a cease and desist order in place because a hearing must be held first. In the meantime, consumers are at risk from fraudulent practices. The bill would permit the commissioner to issue emergency cease and desist orders without a prior hearing if there were a threat of immediate and irreparable harm to the public from conduct one would reasonably believe to be fraudulent, misleading, or otherwise in violation of the Act.

Also, the bill would authorize the commissioner to order an unregistered agent or representative to cease or desist from selling securities or investment advising and to enjoin fraudulent conduct in addition to specific sales of securities. Currently, the commissioner only can enjoin unregistered dealers or investment advisers, but not unregistered agents of dealers or representatives of advisers. However, agents and representatives constitute the vast majority of individuals who are selling securities and advising consumers. Since they do the same things dealers and advisers do, they should be subject to the same cease and desist authority of the commissioner.

Likewise, under the current act, the commissioner only can enjoin the sale of a named security, not a fraudulent practice. Thus, the dealer or agent could simply cease selling the specific security but continue the fraudulent practice in regard to other securities. The commissioner needs the authority to enjoin the fraudulent practices, and the bill would provide that authority.

The bill also would provide needed criminal penalties against corporations and other entities. Because such entities currently cannot be held criminally responsible, they simply can hire new agents to perpetrate on-going fraud, and the most that can happen to the entity is that the commissioner would fine it.

Like the provisions for broadened criminal liability, the bills addition of civil penalties for investment advisers would foster consumer protection. Investment advisers have at least as much potential to harm consumers as do sellers of securities. However, advisers currently cannot be held liable in

damages for fraudulent advice or advice skewed by conflicts of interest. Investment advisers and representatives have great influence over investors and great potential to harm them. Civil liability is needed to ensure that influence is not abused. Even though investors can sue under the Deceptive Trade Practices Act, a specific cause of action for securities fraud would be more appropriate.

Finally, by making investor education part of the board's mission, the bill would help prevent consumer fraud. The board cannot control all dealers and investment advisers, so an educated public is necessary to preventing fraud. Also, more money is flowing into the securities markets and more novice investors are entering the market. In fact, investments in securities total more than the deposits in banks, savings and loans, and credit unions combined. Thus, educating consumers about investing is essential to protecting these consumers and their money.

OPPONENTS SAY:

Though the bill would separately define "federal covered investment advisers" from "investment advisers," it appears to make the federal covered advisers a subset of all investment advisers. In doing so, it would leave the statute unclear whether other references to "investment advisers" include federal covered investment advisers who should be exempt from any state regulation other than notice filing.

For example, the ambiguity allows the definition of "investment adviser representative" to be interpreted also to include representatives of federal covered investment advisers. Under the bill, investment advisers and representatives are required to register with the commissioner. Federal law, however, does not even permit the state to require notice filing, much less registration, of representatives of federal covered investment advisers who do not have a place of business in Texas.

Further, the civil liability provisions might be read to impermissibly impose liability on federal covered investment advisers and their representatives who fail to register under the Act.

NOTES:

The companion bill, SB 306 by Harris, is pending before the Business and Commerce Committee.

The fiscal note indicates that the bill would cost the state approximately $80,000 and would require one additional FTE per year due to the new education functions ascribed to the agency and because of the expenses associated with two new board members.