Texas Sunset Advisory Commission

STAFF EVALUATION

Advisory Council on Technical-Vocational Education

Office of State-Federal Relations

Texas Advisory Commission on Intergovernmental Relations

State Securities Board

Texas Commission on the Arts

A Staff Report
to the
Sunset Advisory Commission

1982

SUNSET ADVISORY COMMISSION

STAFF REPORT

on the

STATE SECURITIES BOARD

1982

FOREWORD

Over the past several years, there has been a sustained interest among the states in a new concept in legislative review popularly described as sunset. Since 1976, more than half the states have enacted legislation which embodies the primary element of sunset, the automatic termination of an agency unless continued by specific action of the legislature.

The acceptance of this concept has been aided by a general agreement that the normal pressures of the legislative process tend to prevent a systematic review of the efficiency and effectiveness with which governmental programs are carried out. The sunset process is, then, an attempt to institutionalize change and to provide a process by which a review and redefinition of state policy can be accomplished on a regular systematic basis.

The Texas Sunset Act (Article 5429K, V.A.C.S., as amended) was enacted by the 65th Legislature in 1977. Under the provisions of the Act, agencies are automatically terminated according to a specified timetable, unless specifically continued by the legislature.

To assist the legislature in making the determination of whether an agency should be continued and, if continued, whether modifications should be made to its operations and organizational structure, the Act establishes a ten-member Sunset Advisory Commission composed of eight legislative members and two public members. The commission is required to evaluate the performance of the agency in accordance with specific criteria set out in the Act and to recommend necessary changes resulting from the findings of the evaluation.

The process by which the commission arrives at its recommendations moves through three distinct phases beginning with a self-evaluation report made by the agency to the commission. The second phase involves the preparation of a report to the commission by its staff, evaluating the activities of the agency, and proposing suggested changes for commission consideration. The final phase involves public hearings on the need to continue or modify an agency and the development of commission recommendations and legislation, based on the agency self-evaluation, staff report, and public testimony.

The Sunset Commission's findings, recommendations, and proposed legislation are then required to be transmitted to the legislature when it convenes in regular session.

INTRODUCTION AND ORGANIZATION OF AGENCY REVIEWS

This sunset staff evaluation covers the following state agencies:

Advisory Council on Technical-Vocationl Education
Office of State-Federal Relations
Texas Advisory Commission on Intergovernmental Relations
State Securities Board
Texas Commission on the Arts

The Texas Sunset Act abolishes these agencies on September 1, 1983 unless each is re-established by the 68th Legislature.

The staff reviewed the activities of these agencies according to the criteria set out in the Sunset Act and has based its conclusions on the findings developed under these criteria.

Taken as a whole, these criteria direct the review of an agency to answer four primary questions:

1. Does the state need to perform the function or functions under review?
2. Could the public still be adequately served or protected if the functions were modified?
3. Is the current organizational structure the only practical way for the state to perform the function?
4. If the agency is continued and continues to perform the same functions, can changes be made which will improve the operations of the agency?

The report is structured to present the performance evaluation of each agency separately. The application of the across-the-board recommendations developed by the commission to deal with common problems are presented in a chart at the end of each report and are not dealt with in the text except in one instance. When the review develops a position which opposes the application of a particular recommendation, the rationale for the position is set forth in the text.

SUMMARY OF STAFF FINDINGS AND CONCLUSIONS

SUMMARY

Organization and Objectives

The State Securities Board was created in 1957 and is currently active. The board is composed of three members appointed by the governor with consent of the senate for overlapping six year terms. Members must be citizens of the state and may not be licensed to sell, or entitled to deal in securities. Operations of the board are supported by general revenue appropriations which totalled $1.5 million in fiscal year 1981. Fee revenues from the regulation of securities during 1981 totalled $6.6 million. For fiscal year 1982, the agency will have a staff of 56.5 and is appropriated $1,829,632 from the General Revenue Fund with fee revenues projected at $7,314,000. For fiscal year 1983, the appropriation is $1,843,222 and fee revenues are projected at $8,415,000.

Securities regulation in Texas takes the general form used by most other states. The structure of the regulation provides for prior approval by the state of the sale of securities in Texas; the imposition through licensing of minimum standards for individuals and firms engaged in selling securities or offering investment advice; and enforcement efforts directed toward violations of the state act.

In regulating the sale of securities within the state, Texas uses the basic premise of protecting the investor at the initial point of issuance of securities to the public. This is done under the regulatory concept known as "merit regulation." Under this approach the agency is directed to determine prior to sale that the securities offering is "fair, just and equitable" to the investor. To arrive at this conclusion, the agency has developed guidelines on which to base its decision to approve or disapprove the sale. The guidelines set general standards for certain elements of the financial and operating structure of the offering of securities. These general standards include requirements for underwriting commissions, offering expenses, cheap stock, options and warrants, offering price, shareholder voting rights, debt and interest coverage, and promoters investment. Under the Act, the agency also requires the disclosure of certain material facts and requires that these facts not be structured in such a way as to be false or misleading to the investor. In addition, the agency requires that before securities initially issued in other states can be sold by a registered dealer in Texas, certain conditions must be met. In fiscal year 1981, the agency approved 2,335 permits representing a value

of $28 billion. During that same period, 284 applications valued at $235 million were abandoned, withdrawn or denied.

In addition to regulating the sale of securities, Texas currently requires that all persons or firms selling securities or offering investment advice must be registered with the agency. The requirements for registration involve passing an examination on general securities principles and state law. Dealers and investment advisors are also required to provide the agency with evidence of financial solvency. No minimum education or experience requirements are necessary to take the examination. Once the examination and financial solvency requirements are met, upon payment of a fee, a registration certificate is issued and is renewed on an annual basis. The agency currently regulates over 2,100 dealers, 260 investment advisors and 16,000 agents or salesmen.

Enforcement activities of the agency are centered on detection and prevention of violations of the Securities Act, including illegal sales of unregistered, non-exempt securities, sales of securities by unregistered dealers and fraudulent sales of securities. Violations of the Act are identified through investigation of consumer complaints, referrals from other agencies and local law enforcement officials and by monitoring advertisements for investors in major newspapers throughout the state. The primary emphasis of the enforcement effort is on investigation of suspected fraudulent conduct in the sale of securities to Texas residents. Cases investigated by the agency may result either in administrative action by the commissioner or in civil or criminal actions brought by the attorney general or district attorneys. Agency attorneys participate in the drafting of pleadings and orders and are present at the trial to provide assistance to the attorney litigating the matter. During 1981 more than 250 investigations were in progress with 26 indictments for securities violations returned and 10 convictions obtained.

The review and evaluation of the agency indicates that its regulatory activities generally serve to ensure an adequate level of public protection. However, the review did show that modifications in the board's operations would increase the efficiency and effectiveness of the agency's regulatory activities.

Policy-Making Structure

The policy-making structure and its composition are generally appropriate for an agency of this type. However, the structure of the board could be strengthened

by adding standard sunset language dealing with member qualifications, selections and grounds for removal.

Overall Agency Administration

The review of the overall administration of the agency focused on determining whether the operating policies and procedures of the agency provide a satisfactory framework which is adequate for the internal management of personnel and funds, and which satisfies reporting and management requirements placed on the agency and enforced through other state agencies. The results indicate that the administration of the agency is generally conducted in an efficient manner; however, improvements in the voucher processing procedures, and compliance with the statutory provision to deposit all fees daily to the treasury would result in cost savings to the agency and increased revenues to the state. In addition, it was determined that granting the board statutory authority to refund any fees as necessary from the General Revenue Fund would eliminate the need for a suspense fund thus reducing any unnecessary delays in the deposit of funds to general revenue and the workload associated with managing a suspense fund. The review also indicated that implementing procedures to index and publish written opinions by the staff counsel regarding the availability of exemptions from registration would provide a valuable guide to individuals regulated by the statute on how the agency's rules or the Act is interpreted or applied to a particular set of circumstances.

Evaluation of Programs

The review of the agency's program activities focused on the extent to which these activities achieve the objectives of the Securities Act: to protect the public by regulating securities sold and the persons who sell securities, and by investigating and prosecuting securities fraud. The review also sought to determine if areas exist where additional efficiencies in operation could be achieved.

Dealer Registration. Review of the licensing process for dealers and salesmen revealed that it functions in a timely and efficient manner; however, several changes were identified which could improve the operations of the dealer registration division. Eliminating the statutory requirement to issue a separate registration certificate for each salesman and allowing the agency to provide dealers with a single listing of all salesmen employed would substantially reduce the agency's workload and costs. The review also showed that "inequitable practice in the sale of securities," one of the bases for denial or revocation of a license, has never been

defined. The promulgation of rules and regulations defining inequitable practice would provide adequate notice to the licensees and the general public on how the Act is interpreted and administered. Review of the license fees for dealers and salesmen indicate that they have been changed only once since they were established in 1935. In addition, although there is approximately twice as much work associated with processing an initial application as a renewal the fees are the same. Increasing the fees for initial applications would ensure that license fees keep pace with the costs of administration and would establish an appropriate differential between the cost of obtaining a license and the cost of renewing a license.

Securities Registration. The review of the securities registration division indicated that despite significant increases in the volume and complexity of issues being registered, the agency has continued to process and evaluate applications for registration in a timely and thorough manner; however, several areas of concern were noted. Evaluation of the processes to register securities indicated that the board needs to initiate formal adoption as rules of all informal guidelines currently used in order to comply with the Administrative Procedure Act and its own rules, and to afford the public greater notice of how the agency interprets and administers the provisions of the Securities Act. The review also indicated that verification of how consistently statutory requirements and rules and regulations have been applied was not possible since waivers from the rules granted by the agency have not been consistently documented. Initiating a process to document waivers granted from published guidelines will ensure that reasonably consistent decisions on similarly structured securities offerings are made.

In addition, the review showed that the revenues to the state decreased in fiscal year 1981 by more than $12 million due to a rule change approved by the board regarding money market funds. Establishing the fee structure for these funds in the statute would be consistent with all other fees charged by this agency as well as other licensing agencies and would allow the legislature to determine the appropriate fee for registration of these funds.

The review also identified needed statutory changes in two of the provisions of the Act exempting certain securities from registration requirements. First, Section 5.I(c) currently requires that prior to each sale claimed to be exempt under that provision the issuer file a notice with the commissioner. Since most of the exemptions are self-executing and do not require a filing, and no compelling reason

could be found for a filing under 5.I(c), elimination of the requirement would reduce unnecessary costs to both issuers and the agency. Secondly, section 5.0 of the Act provides for exemption from registration provided certain conditions are met. In setting out these conditions, reference is made to publishing specified information about the issuer in certain named securities manuals. Because such reference is not standard statutory construction and prevents the board from taking responsibility for assuring these manuals meet certain standards, deleting reference to these manuals and allowing for use under the exemption only those manuals approved by the board would provide it with sufficient authority to protect Texas investors.

Finally, a review of the workload of the securities registration division showed that the caseload per analyst, in terms of original applications processed, has almost doubled in the last four years. The increase in volume of applications has been coupled with growing complexity in the types of securities offerings being registered, requiring additional staff time and effort. Records indicate the average age of files has been increasing. These increases are significant since even a short delay in resolving an application can be of critical importance to an issuer. Additional staff for the securities registration division would reduce or maintain the caseload per analyst and the time required to process applications for registration.

Enforcement. The review of the enforcement division of the agency showed that the agency actively investigates and assists in the successful prosecution of violations of the Act; however, several statutory changes were identified which would further assist enforcement efforts. Currently restitution for a person defrauded in connection with the sale of securities can only be obtained by filing under both the Deceptive Trade Practices Act and the Securities Act. The continued ability of the attorney general to obtain restitution by this means is subject to some question, particularly in view of a recent federal court case. Providing for restitution under the Securities Act would ensure a continuing means of obtaining restitution, especially for the small investor.

The review also indicated that the three-year statute of limitations applicable to prosecutions of fraud in connection with the sale of securities is not sufficient. Since the injury to an investor is not often immediately apparent when a fraudulent sale of securities is made, a significant number of cases investigated by the agency cannot be pursued due to statute of limitations problems. Providing

a five-year statute of limitations in the Securities Act would assist the agency in its efforts to prosecute individuals for fraud.

In addition, the review indicated that the punishment for securities fraud contained in the penal provisions of the Securities Act needs to be increased. Currently district attorneys seeking a stiff penalty for cases of securities fraud involving large sums of money must prosecute under the theft provisions of the Penal Code rather than the penal provisions of the Securities Act. This involves establishing an intent to steal which is often difficult to prove in a securities case. Providing heavier penalties in the Securities Act for fraudulent sales of securities where the transaction exceeds $10,000 would assist the agency in its enforcement efforts.

The review also indicated that under current procedures any person taking exception to the commissioner's denial of a securities registration may request a hearing before the board. The board may deny the request, in which case the commissioner presides. Since these procedures do not guarantee a party aggrieved by a denial order of the commissioner a review by an impartial body clearly removed from the original decision, as well as imposing unnecessary costs on both the agency and the applicant, the Securities Act and the agency's rules and regulations should be amended to provide an aggrieved applicant a right to a hearing before the board when requested.

A review of the workload of the enforcement division indicated that staff limitations have hampered the agency's ability to detect and prevent violations of the Act. The agency must concentrate its enforcement efforts on violations involving fraud, and even among these cases, it must selectively pursue those in which the greatest harm has been inflicted. Additional staff for the enforcement division would reduce the backlog of cases not being worked for lack of time and personnel.

A final concern identified relates to the provision in the Act requiring review of agency orders in district court by "trial de novo." Removal of the "trial de novo" provision, thereby allowing use of the "substantial evidence" approach as set out in the Administrative Procedure Act, would permit a court to review the record of a board hearing as a basis for a ruling. This change would help to expedite the disposition of appeals of board actions.

Other Sunset Criteria

The review of areas of Open Meetings/Open Records, EEOC/Privacy, public participation and conflicts of interest, shows a general compliance with the requirements concerning these areas. However, the Securities Act considers records of dealers and salesmen to be confidential and an analysis of the types of documents closed to public inspection shows that this restriction should be removed.

Need to Continue the Function

The review indicated that there is a continuing need to regulate the securities industry in Texas.

Approaches for Sunset Commission Consideration

I. MAINTAIN THE CURRENT REGULATION WITH MODIFICATIONS

A. Agency operations

1. Policy-making structure

   a. Amend the statute to include the across-the-board recommendations concerning conflicts of interest, grounds for removal, and selection of board members. (statutory)

2. Overall agency administration

   a. Reduce the error rate in vouchers for issuance of warrants by taking advantage of technical assistance offered by the comptroller's office for agencies experiencing difficulties with voucher processing, and following the procedures promulgated by the comptroller's office and the State Purchasing and General Services Commission. (management improvement - non-statutory)

   b. Comply with statutory provisions by depositing all fees to the treasury on a daily basis. (management improvement - non-statutory)

   c. Amend the statute to grant the board the authority to refund permit or license fees as necessary from the General Revenue Fund. (statutory)

   d. Initiate a procedure to index and publish written opinions prepared by the staff counsel regarding the availability of exemptions from registration. (management improvement - non-statutory)

3. Evaluation of programs

   a. Amend the statute to eliminate the requirement that a registration certificate be issued for each salesman or agent. (statutory)

   b. Amend the board's rules and regulations to define what constitutes inequitable practice in the sale of securities. (management improvement - non-statutory)

   c. Amend the statute to increase the fees for initial applications from $35 to $70 for dealers and from $15 to $30 for salesmen. (statutory)

   d. Amend the board's rules and regulations to formally adopt all informal guidelines currently in use wherever practical. (management improvement - non-statutory)

   e. Initiate a process to document waivers granted from published guidelines in the registration of securities. (management improvement - non-statutory)

   f. Amend the statute to permit the legislature to determine the fee structure for registration of money market funds. (statutory)

   g. Amend the statute to remove the filing requirement under Section 5.I(c) of the Act exempting from registration securities sold by the issuer to not more than 15 persons within a 12-month period. (statutory)

   h. Amend the statute to delete the references to specific securities manuals in Section 5.0 of the Act and allow the board to approve all manuals used. (statutory)

   i. Appropriations for the 1984-85 biennium should include funding for additional personnel in the enforcement division and the securities registration division to assist in analyzing applications for securities registration and in investigating violations of the Act and seeking appropriate sanctions. (non-statutory)

   j. Amend the statute to permit restitution for persons defrauded in connection with the sale of securities. (statutory)

k. Amend the statute to establish a five-year statute of limitations for prosecution of fraud in connection with the sale of securities. (statutory)

l. Amend the statute to provide a stiffer penalty for cases involving securities fraud where the amount of the transaction is $10,000 or more. (statutory)

m. Amend the statute to provide all parties a right to a hearing before the board, when requested, in cases where a securities registration is denied. (statutory)

n. Amend the statute to provide that all appeals prosecuted under the Act be subject to the substantial evidence rule. (statutory)

B. Recommendations for other sunset criteria

1. Open Meetings/Open Records

a. The statutory language which states that all records of dealers and salesmen licensed by the board is confidential should be eliminated so that these records are treated in a fashion similar to those of other licensing agencies. (statutory)

II. ALTERNATIVES

A. Agency reorganization

An analysis of the alternatives of merging the functions of the board with those of another existing agency did not show any significant benefits to be gained.

B. Change in the method of regulation

1. Substitute full-disclosure requirements for the current "merit" standards in the registration of securities.

Under this approach securities registered for sale in Texas would not be required to meet certain "merit" tests concerning areas such as offering price, shareholder voting rights, underwriting commissions and promoters investment designed to ensure that the relationship between the issuer and the new investor is "fair, just and equitable." Instead, companies or individuals issuing securities would be required to disclose specified information in the prospectus necessary for an investor to make an

informed decision. While substituting full-disclosure requirements for the current merit standards would result in less protection to the public from the sale of insubstantial securities, benefits which could be derived include continued state regulation of securities through a less restrictive method than currently available and an increase in the number and type of securities which would be sold in Texas.

2. **Discontinue regulation of investment advisors and their agents.**

This approach would eliminate any licensure of individuals whose sole function is to render investment advice for a fee. Although an investor may be harmed by the rendering of poor advice, since in practice an investment advisor does not generally hold a client's funds or securities, the review showed that the potential for harm is not as great as in the case of a dealer and therefore does not warrant state regulation. Many of these individuals would continue to be recognized or regulated by the Securities and Exchange Commission or by voluntary professional organizations such as the Institute of Chartered Financial Analysts.

AGENCY EVALUATION

The review of the current operations of an agency is based on several criteria contained in the Sunset Act. The analysis made under these criteria is intended to give answers to the following basic questions:

1. Does the policy-making structure of the agency fairly reflect the interests served by the agency?
2. Does the agency operate efficiently?
3. Has the agency been effective in meeting its statutory requirements?
4. Do the agency's programs overlap or duplicate programs of other agencies to a degree that presents serious problems?
5. Is the agency carrying out only those programs authorized by the legislature?
6. If the agency is abolished, could the state reasonably expect federal intervention or a substantial loss of federal funds?

BACKGROUND

Historical Development

The awareness of the economic impact of fraudulent investment schemes led to the comprehensive regulation of securities by the states as early as 1911. Since that time, all states have passed some kind of securities law designed to protect the public in one or more of the following ways: 1) to prohibit fraud in the offer and sale of securities; 2) to require and regulate the licensing of investment advisors, broker-dealers and their agents; and 3) to require the registration of securities.

The first law providing comprehensive regulation of securities was enacted by the Texas Legislature in 1923 in response to substantial losses suffered by investors from worthless securities flooding the state and because the absence of state regulation had encouraged the location in Texas of large numbers of companies selling worthless securities through the mails to people out-of-state. The initial legislation limited regulation of securities to requiring a permit for the sale of all types of corporate securities. The Office of the Secretary of State was authorized to administer the provisions of the Act.

This legislation was repealed in 1935 and was replaced with more comprehensive legislation known as the Texas Securities Act. This legislation encompassed all of the regulatory approaches common to state securities legislation, prohibited fraud and misrepresentation in the sale of securities and required registration of securities not otherwise exempted, in addition to licensing brokers and dealers.

The Texas Securities Act remained relatively unchanged until 1955 when problems related to two exemptions in the Act resulted in enactment of a new Securities Act and the Insurance Securities Act. In 1953, a court decision had exempted sales of stock for the purpose of capitalizing insurance companies from the Securities Act. This resulted in more than one thousand of these companies being formed and selling more than $100,000,000 in stock, much of it reported to be grossly watered and highly speculative. In addition, it was determined that the exemptions in the Act for insurance companies had resulted in significant amounts of capital being diverted to unscrupulous promotions in insurance securities characterized by high pressure sales to unsophisticated purchasers with large profits to the promoters.

The legislation enacted in 1955 resulted in insurance securities being registered by the Board of Insurance Commissioners while regulation of other types of securities remained the responsibility of the Secretary of State. It soon became apparent that this dual system of securities regulation was awkward and unwieldy. One difficulty created by the administration of separate statutes was that securities dealers were required to have separate dealer's licenses for insurance securities and other types of securities. In 1957, the 55th Legislature addressed the problem by creating an independent administrative agency with regulatory powers over all securities sold in the state.

The state is not the only governmental entity which regulates the securities industry in Texas. Any securities business being conducted on an interstate basis is subject to the provisions of the federal securities laws. The Securities and Exchange Commission (SEC), organized in 1934, is the agency charged with administering the federal securities laws. The SEC registers securities, provides for the registration and regulation of securities exchanges, registers and regulates securities brokers and dealers, and investment advisors. Regulation of over-the-counter brokers, dealers and their agents also occurs through the National Association of Securities Dealers, a national securities association registered and supervised by the Securities and Exchange Commission.

Current Programs and Objectives

The State Securities Board was created in 1957 and is currently active. The board is composed of three members appointed by the governor with consent of the senate for overlapping six year terms. Members must be citizens of the state and may not be licensed to sell, or entitled to deal in securities. Operations of the board are supported by general revenue appropriations which totalled $1.5 million in fiscal year 1981. Fee revenues from the regulation of securities during 1981 totalled $6.6 million. For fiscal year 1982, the agency will have a staff of 56.5 and is appropriated $1,829,632 from the General Revenue Fund with fee revenues projected at $7,314,000. For fiscal year 1983, the appropriation is $1,843,222 and fee revenues are estimated to be $8,415,000.

Securities regulation in Texas takes the general form used by most other states. The structure of the regulation provides for prior approval by the state of the sale of securities in Texas; the imposition through licensing, of minimum standards for individuals and firms engaged in selling securities or offering

investment advice; and enforcement efforts directed toward violations of the state act.

In regulating the sale of securities within the state, Texas uses the basic premise of protecting the investor at the initial point of issuance of securities to the public. This is done under the regulatory concept known as "merit regulation." Under this approach the agency is directed to determine prior to sale that the securities offering is "fair, just and equitable" to the investor. To arrive at this conclusion, the agency has developed guidelines on which to base its decision to approve or disapprove the sale. The guidelines set general standards for certain elements of the financial and operating structure of the offering of securities. These general standards include requirements for underwriting commissions, offering expenses, cheap stock, options and warrants, offering price, shareholder voting rights, debt and interest coverage, and promoters investment. Under the Act, the agency also requires the disclosure of certain material facts and requires that these facts not be structured in such a way as to be false or misleading to the investor. In addition, the agency requires that before securities initially issued in other states can be sold by a registered dealer in Texas, certain conditions must be met. In fiscal year 1981, the agency approved 2,335 permits representing a value of $28 billion. During that same period, 284 applications valued at $235 million were abandoned, withdrawn or denied.

In addition to regulating the sale of securities, Texas currently requires that all persons or firms selling securities or offering investment advice must be registered with the agency. The requirements for registration involve passing an examination on general securities principles and state law. Dealers and investment advisors are also required to provide the agency with evidence of financial solvency. No minimum education or experience requirements are necessary to take the examination. Once the examination and financial solvency requirements are met, upon payment of a fee, a registration certificate is issued and is renewed on an annual basis. The agency currently regulates over 2,100 dealers, 260 investment advisors and 16,000 agents or salesmen.

Enforcement activities of the agency are centered on detection and prevention of violations of the Securities Act, including illegal sales of unregistered, non-exempt securities, sales of securities by unregistered dealers and fraudulent sales of securities. Violations of the Act are identified through investigation of consumer complaints, referrals from other agencies and local law enforcement

officials, and by monitoring advertisements for investors in major newspapers throughout the state. The primary emphasis of the enforcement effort is on investigation of suspected fraudulent conduct in the sale of securities to Texas residents. Cases investigated by the agency may result either in administrative action by the commissioner or in civil or criminal actions brought by the attorney general or district attorneys. Agency attorneys participate in the drafting of pleadings and orders and are present at the trial to provide assistance to the attorney litigating the matter. During 1981 more than 250 investigations were in progress with 26 indictments for securities violations returned and 10 convictions obtained.

REVIEW OF OPERATIONS

The evaluation of the operations of the agency is divided into general areas which deal with: 1) a review and analysis of the policy-making body to determine if it is structured to be fairly reflective of the interests served by the agency; 2) a review and analysis of the activities of the agency to determine if there are areas where efficiency and effectiveness can be improved both in terms of the overall administration of the agency and in the operation of specific agency programs.

Policy-Making Structure

In general, the structure of a policy-making body should have as basic statutory components, specifications regarding composition of the body and the qualifications, method of selection and grounds for removal of members. These should provide executive and legislative control over the organization of the body and ensure that the members are competent to perform required duties, that the composition represents a proper balance of interests impacted by the agency's activities, and that the viability of the body is maintained through an effective selection and removal process.

The State Securities Board is composed of three members appointed by the governor with consent of the senate for overlapping six-year terms. Members must be citizens of the state and may not be licensed to sell, or entitled to deal in securities. The review indicated that the structure of the board was generally appropriate for this type of agency; however, several improvements could be made in the statute relating to the qualifications, selection and grounds for removal of board members.

In each of these areas, the Sunset Commission has adopted certain standard recommendations intended to strengthen the policy-making structure. First, the statute should set out basic conflict-of-interest criteria that a person should meet to be qualified to serve on the board. These conflict-of-interest provisions are designed to minimize any unfair bias towards the regulated occupation. Second, the statute should require that selection as a board member be made without regard to race, creed, sex, religion or national origin. Finally, the statute should clearly specify as grounds for removal of board members, attendance at meetings and the lack of any specified qualifications.

Overall Administration

The evaluation of the overall agency administration focused on determining whether the operating policies and procedures of the agency provide a framework which is adequate for the internal management of personnel and cash resources, and which satisfies reporting and management requirements placed on the agency and enforced through other state agencies.

The objectives of the administrative activities of the agency include: 1) directing and supervising the administration of the Securities Act; 2) managing agency fiscal affairs, data processing, personnel records, purchasing, inventory and deposits of revenue; 3) budgeting for the agency; and 4) responding to public inquiries on interpretation and requirements of the Act. Review of the administrative activities of the board indicated that the agency is generally administered in an efficient manner; however, the agency has experienced difficulties in connection with the 1979 purchase of an in-house data processing system. The equipment purchased had far more capability than the agency's data processing personnel and, since information stored in the computer was unreliable, it provided few benefits to the agency. As a result, the agency has decided to abandon the system and contract for data processing services from the State Purchasing and General Services Commission to meet its future automation needs. In addition, several other areas were identified where changes in the agency's administrative procedures or the statute would result in cost savings to the agency, expedite the deposit of revenues to the General Revenue Fund or provide greater notice to the public on how the Act is interpreted.

Processing of Vouchers. The review indicated that unnecessary costs are incurred by the agency due to returns of vouchers submitted to the comptroller for the issuance of warrants. A review of the comptroller's records showed that 17 percent of the vouchers were submitted with errors during fiscal year 1981. Seventy-six percent of those vouchers had to be returned to the agency for correction of the errors identified. This rate is significantly higher than the average five percent reject rate experienced by other state agencies. The most common examples of errors found in the vouchers were: 1) failure of the agency to send the voucher to the Purchasing and General Services Commission in instances where bidding was required; 2) incorrect or missing vendor ID numbers; and 3) failure to obtain signature approval by department heads. The cost incurred by the agency for reprocessing these rejected vouchers during fiscal year 1981 was

approximately $4,200. The agency should take advantage of technical assistance offered by the comptroller's office for agencies experiencing difficulties with voucher processing and follow the procedures promulgated by the comptroller's office and the State Purchasing and General Services Commission.

Daily Deposits. Provisions of the Securities Act require the agency to deposit all fees to the treasury on a daily basis. Review of the agency records documenting deposits to the State Treasury indicates the agency generally deposits an average of $143,000 to the State Treasury once a week. Since funds held by the agency cannot earn interest, the loss in interest earnings to the General Revenue Fund during fiscal year 1981 was estimated to be $5,000. Instituting a procedure to make deposits on a daily basis will put the agency in compliance with the Act and produce additional interest income for the state.

Suspense Account. Money deposited to the General Revenue Fund cannot be refunded without specific statutory authorization. The review indicated that the agency does not have this authority and has established a departmental suspense account under Article 4388, V.A.C.S., in order to refund fees when necessary. All revenues to the agency are deposited to the suspense account and any funds not subject to refund or funds associated with applications for registration of securities or of salesmen and dealers on which final action has been taken are cleared every 30 days to the General Revenue Fund.

A review of the status of funds held in the agency's suspense accounts during fiscal years 1980 and 1981 show that the ending balance increased 76 percent and the percentage of funds in the account more than 3 months old increased 108 percent. Refunds during fiscal year 1981 constituted only 3 percent of the total revenues deposited to the suspense account.

Although revenues held in the suspense account do earn interest at the same rate as other state funds, warrants may not be issued against funds held in suspense accounts. As a result, unnecessarily depositing funds not subject to refund to the departmental suspense account or not clearing funds from the suspense account to the General Revenue Fund as soon as possible, impacts the ability of the state to honor warrants paid from general revenue.

An alternative to the use of a suspense account which would minimize unnecessary delays in the deposit of revenues to the General Revenue Fund and would reduce the agency's workload in managing these funds is to grant the

Securities Board the statutory authority to refund permit or license fees as necessary from general revenue and eliminate the need for a suspense fund.

Opinion Letters. The review indicated that the agency receives frequent inquiries from the public as to whether, based on a particular fact situation, a certain exemption is available and registration is not required. The staff legal officer prepares over 800 written responses per year, signed by both the commissioner and the legal officer, restating the facts involved and offering the staff opinion as to the availability of the exemption.

Provisions of the Administrative Procedure Act provides for the indexing of commissioner's orders. The principle underlying this requirement, that the public should be on notice of how an act is being interpreted by the agency charged with its administration and enforcement, appears to apply to the staff opinions issued by the Securities Board. Precedent for indexing this type of opinion has been set at the national level by the Securities and Exchange Commission which currently indexes and publishes "no action" letters stating that the commission will take no action to require registration based on a given set of facts.

Implementing procedures to index and publish written opinions prepared by the staff counsel regarding the availability of exemptions from registration will provide a valuable guide to individuals regulated by the statute as to how the agency's rules and the Act is interpreted or applied to a particular set of circumstances.

Evaluation of Programs

The review of the agency's program activities focused on the extent to which these activities achieve the objectives of the Securities Act: to protect the public by regulating securities sold and the persons who sell securities, and by investigating and prosecuting securities fraud. The review also sought to determine if areas exist where additional efficiencies in operation could be achieved.

Dealer Registration

The objective of the dealer registration activity of the board is to ensure that persons authorized to sell securities or offer investment advice in the state meet minimum standards of competency. The Securities Act mandates the registration of all persons or companies engaged in the sale or offer for sale of securities. The requirements for registration involve passing an examination on general securities principles and state law. Dealers and investment advisors are also required to provide the agency with evidence of financial solvency. No minimum education or

experience requirements are necessary to take the examination. Once the examination and financial solvency requirements are met, upon payment of a fee, the registration certificate is issued and is renewed on an annual basis. The agency currently regulates over 2,100 dealers, 16,000 salesmen and 260 investment advisors. Review of the licensing process for dealers and salesmen revealed that it functions in a timely and efficient manner; however, several changes were identified which would result in increased revenues, cost savings or greater assurance that all individuals meet minimum standards.

License Fees. The Securities Act currently sets the fee for the filing of either an original or renewal application at $35 for dealers and $15 for salesmen. The review showed that these fees have been increased only once since they were originally set in 1935 at $25 and $10, respectively. In contrast, the cost of regulating securities has increased from $135,000 in 1958 when the board was established to more than $1.8 million in 1982.

The review also indicated that the processing of original applications requires approximately twice as much time as processing renewal applications. Generally, much more information must be filed in connection with an original application than a renewal; therefore, more staff time is required to review the data submitted and to send deficiency letters notifying the applicant of omissions and requesting needed information. In addition, a criminal history check is run on each new applicant and, in the case of dealer applicants, checks are made with other states where the dealer is registered. Since a renewal application amounts essentially to an update of information on file with the agency, the processing time is substantially reduced.

Doubling the current license fee for initial applications from $35 to $70 for dealers and from $15 to $30 for salesmen, and leaving renewal fees at the current level, would establish a differential between original and renewal application fees which adequately reflects the difference in agency effort, and would result in approximately $80,000 in increased revenues to the General Revenue Fund.

Registration Certificates. Section 18 of the Securities Act requires that for each securities agent or salesman registered under the Act, the commissioner issue a registration certificate stating the registrant's name and residence, and the address of the dealer requesting the salesman's registration. Certificates are issued to the sponsoring dealer for each salesman meeting all licensure requirements. Annual renewal of these certificates is accomplished by mailing the

renewal notices and new certificates to the dealers who generally submit a single payment for the renewal of all salesmen currently employed.

Generally, where licensees are not self-employed, a license or registration certificate is necessary as evidence of licensure to prospective employers who have not been involved in the licensure process. In contrast, under the Securities Act, securities salesmen must be employed by a registered dealer or investment advisor who is responsible for submitting the application for registration, renewing the registration annually and cancelling the license when the salesman terminates employment. Since any succeeding employer is actively involved in the registration process, notification that the licensure requirements have been met could be accomplished by means other than a separate registration certificate for each salesman employed.

In addition, the results of the review indicated that the workload associated with the issuance, renewal and amendment of individual salesmen and agent certificates is substantial. Processing original certificates alone accounts for approximately 40 percent of the registration division's workload. The time involved in processing amendments is also substantial since any change in the information shown on the certificate necessitates the dealer submitting the old certificate and a new certificate being issued by the agency. Updates are frequently required since residency changes are common among securities salesmen, and brokerage firms continue to engage in mergers and acquisitions which may involve changes in the certificates of hundreds of salesmen.

The agency's workload could be substantially reduced without impairing the level of protection afforded the public by deleting the requirement of separate registration certificates for salesmen or agents, and allowing the agency to provide dealers with a single listing of all salesman applications approved, both original and renewal. New registrants could be added to the listing and employees terminating employment could be deleted from the listing at any time.

Definition of Inequitable Practice. The results of the review indicated that the need for specific standards concerning business practices in the securities industry is especially important in light of the intricate and intangible nature of securities, and the fact that securities dealers perform banking and custodial functions involving the custody and use of large amounts of customer assets. Although "inequitable practice in the sale of securities" is one of the bases for denial, suspension or revocation of a dealer's or salesman's license, what consti-

tutes an inequitable practice has never been defined by the board in its rules and regulations. The review indicated that there is adequate precedent for defining inequitable practices since both the federal agencies regulating interstate securities transactions have promulgated extensive rules defining these practices. The promulgation of rules and regulations defining inequitable practice by the Securities Board would provide adequate notice to both the individuals licensed by the agency and the general public concerning how the Securities Act is interpreted and administered, and would assist in the enforcement of the Act.

Securities Registration

The objective of the securities registration activity of the board is to protect the investor at the initial point of issuance of securities to the public. This protection is provided under a regulatory concept known as "merit regulation." Under this approach, the agency is directed to determine prior to sale that the securities offering is "fair, just and equitable" to the investor. To arrive at this conclusion, the agency has developed guidelines on which to base its decision to approve or disapprove the sale. The guidelines set general standards for certain elements of the financial and operating structure of the offering of securities. These general standards include requirements for underwriting commissions, offering expenses, cheap stock, options and warrants, offering price, shareholder voting rights, debt and interest coverage, and promoters investment. Under the Act, the agency also requires the disclosure of certain material facts and requires that these facts not be structured in such a way as to be false or misleading to the investor. The agency also requires that before securities initially issued in other states can be sold in Texas, certain conditions must be met. In fiscal year 1981, the securities registration division issued 2,335 permits for securities valued at $28 billion. During the same period, 284 applications for securities valued at $235 million were abandoned, withdrawn or denied.

The review of the securities registration activities of the agency indicated that despite significant increases in the volume and complexity of issues being registered, the agency has continued to process and evaluate applications for registration in a timely and thorough manner; however, several areas were noted where needed changes would result in substantially greater revenue to the state, eliminate unnecessary work both for the applicants and the agency, or provide greater accountability concerning the application of the "merit" standards.

Registration Fees for Money Market. Provisions of the Securities Act establish the fee for registration of securities at 1/10 of one percent of the total amount registered for sale in Texas. This fee was originally established in 1935 and produces 95 percent of the revenue associated with the regulation of securities. The review indicated that, in 1979, the 66th Legislature considered and failed to enact H. B. 530 which would have established a $100 minimum and a $1,000 maximum annual fee on registrations by mutual funds. The agency estimated the fiscal impact of this proposed fee structure would have caused the Securities Board to become a net drain on the General Revenue Fund instead of a net contributor.

After the failure of this legislation, the State Securities Board adopted a rule effective September 1, 1979 which exempted mutual funds from the fee provisions of the Act and substituted the reduced fee schedule shown below. Reasons given by the agency for differentiating between the fees charged for other registrations and money market fund registrations include: 1) money market funds are designed to attract a large volume of comparatively short-term investments; 2) early redemptions are contemplated by both the purchaser and the seller; and 3) these funds continually offer to repurchase their own securities and to issue new securities to new and repeat investors.

Table I

FEE STRUCTURE FOR MONEY MARKET FUNDS REGISTERED BY THE STATE SECURITIES BOARD

Amount Registered		Required Fee
$ 0	- $ 10,000,000	1/10 of one percent of the amount registered or $1,000 per million
$ 10,000,001	- $ 20,000,000	1/20 of one percent of the amount registered or $500 per million
$ 20,000,001	- $ 50,000,000	1/50 of one percent of the amount registered or $200 per million
$ 50,000,001	- $100,000,000	1/100 of one percent of the amount registered or $100 per million
$100,000,001	or more	1/200 of one percent of the amount registered or $50 per million

Agency records show that at the time the reduced fee schedule was proposed only one issuer had registered over $100,000,000 in sales, thus qualifying for the greatest reduction in fees, and only two issuers would have qualified for the next lowest rates. The loss in revenue to the state at the time the rule was adopted was estimated by the agency to be $800,000 in 1980 and $450,000 in 1981. Documents reviewed in connection with the adoption of this rule indicate that the rule was designed to provide some relief to the money market funds for the reasons indicated above while maintaining the agency's position as a net contributor to general revenue. The results of the review indicate that although the agency has continued to raise tual funds from the fee provisionmore revenues that it is appropriated, the number of issuers qualifying for the greatest reduction in fees has grown from one to nineteen and the actual loss in fee revenues in 1981 was estimated to be more than $12,000,000 rather than the $450,000 which had been projected. Establishing the fee structure for money market funds in statute would be consistent with all other fees charged by this agency as well as other licensing agencies and would allow the legislature to determine the appropriate level of fees.

Adoption of Guidelines as Rules. Under the Securities Act, all securities which are registered for sale in Texas must be "fair, just and equitable." Since the Act does not specifically define what constitutes a "fair, just and equitable" offering, the board has promulgated rules and regulations which establish standards for determining which securities are eligible for registration. These rules and regulations are not only necessary in order for the staff to make its determination, but also inform prospective issuers of securities of the requirements that must be met in order to issue securities in Texas, one of the leading capital markets in the United States. The review of the securities registration activity of the board showed that the agency uses guidelines for determining the eligibility of securities for registration which have not been formally adopted as rules and regulations by the board. One area where this has occurred has been in the registration of oil and gas programs where the agency has been using guidelines adopted by the North American Securities Administrators Association (NASAA) rather than the guidelines established by its own rules in 1978. During fiscal year 1981, 188 applications for registration of oil and gas programs valued at $430 million were approved on the basis of these alternative guidelines.

The Administrative Procedure Act defines rules as "... any agency statement of general applicability that implements, interprets or prescribes law or policy or

describes the procedure or practice requirements of an agency" and sets out the procedures for adopting such rules. The informal guidelines currently used by the agency clearly seem to fall within this definition. In addition, the board's own rules state that it is "...the intent of the board to supplant unwritten policies and guidelines with written rules and to revise existing rules to better reflect the realities of current financial, commercial and regulatory principles and practice."

The board should initiate the formal adoption of all informal guidelines currently used as rules wherever practicable in order to comply with the requirements of the Administrative Procedure Act and its own rules, and in order to afford the general public and the industry with adequate and equal notice of how the agency interprets and administers the provisions of the Securities Act.

Documenting Waivers. Provisions of the Securities Act grant the board the authority to waive any requirement of any agency rule or regulation and the board, in turn, has delegated this authority to the commissioner. The review showed that waivers are routinely granted at various points in the review process, but the actual incidence of these waivers, the consistency with which they are applied, and the impact on the public could not be determined since records of waivers are not kept. The review indicated that the difficulty in establishing formal rules which adequately define and quantify merit standards has typically resulted in a significant amount of administrative discretion being exercised by agency staff in merit regulation states such as Texas. The agency can minimize any concerns over the exercise of such discretion and assure that reasonably consistent decisions on similarly structured securities issues are made based on formal standards rather than unpublished informal policies whenever possible, by initiating a process to document waivers granted from published guidelines.

Filing Requirements. Other provisions of the Securities Act provide a number of exemptions from registration for certain securities or transactions where regulation is provided by other entities or where certain types of investors would not significantly benefit from the protection provided by securities registration. Most of these exemptions are self-executing and thus do not require action on the part of the agency staff or the issuer who qualifies under them. One exception to this rule is the exemption contained in Section 5.I(c) of the Act exempting from registration securities sold by the issuer to not more than 15 persons within a 12-month period. The statute currently requires that the issuer file a notice with the commissioner prior to each sale claimed to be exempt. The

review showed that there are no similar filing requirements under Sections 5.I (a) and (b) of the Act which are also concerned with small offerings to the well-informed investor and no compelling reasons were identified to continue a filing requirement for this exemption. Since approximately 80 filings are made under the exemption annually, the elimination of this requirement will reduce any unnecessary costs to both the issuers and the agency.

Elimination of References to Securities Manuals. Under the provisions of the Act, a person offering securities sold initially in other states may be exempted from registration in Texas. An exemption is allowed if the security is listed in Moody's Investment Service, Standard & Poor's Corporation, Best's Life Insurance Reports or other nationally distributed securities manuals approved by the commissioner. At one point in time, the specific manuals named in the statute were publications that could be relied upon as an automatic means to determine quality. This has changed and the publications are not useful for this purpose. Placing them by name in the statute, however, requires that the commissioner use them as a standard. It would be more appropriate to allow the board to designate the specific manuals to be used as a means of granting an exemption. This would provide the agency with the necessary flexibility to protect Texas investors. The statute should be amended to delete the specific names of manuals and to allow the board to approve manuals it deems appropriate.

Staffing Requirements. The review showed that while the number of securities analysts employed by the agency has remained almost constant during the period under review, the division's workload has increased dramatically due to Texas' healthy economy and capital markets, with a particularly marked increase in 1981 as a result in part of rising numbers of mutual fund offerings. Agency records show that the number of original applications filed with the agency has increased 96 percent between 1979 and 1981, thus increasing the caseload per analyst from 125 to 212 during this two-year period. In addition, analysts have also experienced significant increases in the numbers of amendments, renewals and exemption notices filed. Coupled with this increased volume of securities registrations has been the growing complexity of many offerings, requiring research into and evaluation of complicated promoter compensation packages, liability questions, complex conflicts of interest, and other issues. Agency records show that a significant portion of the overall increases in registration activity have been caused by sizeable increases in oil and gas, and real estate offerings, some of the

most complex and difficult offerings to analyze. In the past five years, the number of oil and gas programs have risen 185 percent while real estate offerings have risen 200 percent.

The difficulties in responding to these increases in volume and complexity of offerings are compounded by the time constraints involved in processing applications for registration. In the securities registration process, timing is often of critical importance to the issuer, his broker and potential investors. Where an issuer is planning a distribution of a securities issue in a number of states, if the registration in Texas fails to become effective simultaneously with effectiveness of registration with the Securities and Exchange Commission and other states, the Texas market may, in effect, be cut out of the initial distribution. Texas investors lose the opportunity to invest in that issue, and the issuer and Texas brokers lose the opportunity to sell in Texas. The review showed that the average age of files has increased by approximately two weeks during the period under review. These increases are significant since even a short delay in resolving an application can have far-reaching effects. Additional staff for the division would reduce or maintain the caseload per analyst and ensure the timely processing of applications while maintaining a sufficient level of analysis and review. The cost of one additional securities analyst is estimated to be $23,000.

Enforcement. Enforcement activities of the agency are centered on detection and prevention of violations of the Securities Act, including illegal sales of unregistered, non-exempt securities, sales of securities by unregistered dealers and fraudulent sales of securities. Violations of the Act are identified through investigation of consumer complaints, referrals from other agencies and local law enforcement officials, and monitoring advertisements for investors in major newspapers throughout the state. The primary emphasis of the enforcement effort is on investigation of suspected fraudulent conduct in the sale of securities to Texas residents. Cases investigated by the agency may result either in administrative action by the commissioner or in civil or criminal actions brought by the attorney general or district attorneys. Agency attorneys participate in the drafting of pleadings and orders and are frequently present at trial to provide assistance to the attorney litigating the matter. During 1981, more than 250 investigations were in progress with 26 indictments for securities violations returned and 10 convictions obtained. The review of the enforcement division of the agency showed that the agency actively investigates and assists in the

successful prosecution of violations of the Act; however, several statutory changes were identified which would further assist enforcement efforts.

Restitution. The results of the review showed that the Securities Act currently does not provide for obtaining restitution for persons defrauded in connection with the sale of securities. Although the agency, acting through the attorney general, may seek an injunction to stop fraudulent practices and prevent the further loss of funds by investors, the only way restitution can be obtained for investors already defrauded is by filing under both the Deceptive Trade Practices Act and the Securities Act. As a result of a recent federal court decision which held that the sale of securities does not fall under the Deceptive Trade Practices Act, the continued ability of the attorney general to obtain restitution by this means is subject to some question. In addition, the agency indicated that because its staff does not deal with the Deceptive Trade Practices Act regularly, and thus does not posses the needed expertise in drafting pleadings under that Act, it cannot be as effective in providing assistance to the attorney general if preparing a case for suit and proceeding under the Trade Practices Act than if proceeding solely under the Securities Act.

It is especially important to the small investor to ensure a continuing means of obtaining restitution. Although the Act does provide civil remedies so that an individual who has been defrauded can file suit under the Act, this may not be a practical alternative to the small investor because of the high costs of litigation. The review indicated that the ability to seek restitution can result in significant benefits to defrauded investors. In a recent case, filed after an investigation by the agency, the defendant was ordered to make restitution of $899,900 to 298 consumers. In view of the close parallel between securities fraud and deceptive trade practices and the potential benefits to consumers, provision should be made in the Securities Act for obtaining restitution for violations of the Act where the transaction involves the element of securities fraud.

Statutes of Limitations. The review indicated that although the Act provides penal sanctions for fraud in connection with the sale of securities, the Act does not provide a specific statute of limitations which applies to this provision. In the absence of such a statute of limitations in the Securities Act, the general three-year limitations period prescribed in the Texas Code of Criminal Procedure for felony offenses, other than those specifically listed, would apply.

The review revealed that because the injury to the investor is not often immediately apparent when a fraudulent sale of securities is made, a three-year limit on the period of time during which the state may prosecute securities violators under the penal provisions of the Act is insufficient. Suspicions of wrongdoing by victims of fraud are often allayed by the use of letters excusing delays in dividend or other payments and promising imminent and sizeable returns. As a result of the use of such "lulling" techniques, particularly prevalent in oil and gas securities fraud, victims may often delay for as long as two to three years in filing a complaint with the agency. In these cases when offenses are brought to the agency's attention, insufficient time remains for the staff to conduct a full investigation and prepare a case prior to the running of the statute of limitations. The agency indicated that of the investigations formally closed by the agency in 1980, 60 percent were closed as a result of statute of limitations problems.

Under the Code of Criminal Procedure, the statute of limitations for theft is five years. Since a fraudulent sale of securities amounts to a form of theft, the right of the state to prosecute such crimes where the victims are Texas investors under the penal provisions of the Securities Act should continue for the same period of time as for other types of theft.

Penalties for Fraud. The review indicated that transactions involving fraudulent sales of securities may often be prosecuted under the theft provisions of the Penal Code as well as the penal provisions of the Securities Act. Currently, in a case involving securities fraud where the amount of the transaction is $10,000 or more, a conviction for theft based on that transaction is punishable under the Penal Code by confinement of from 2 to 20 years and/or a fine up to $10,000; a conviction under the Securities Act, based on the same transaction, would carry a maximum penalty of 10 years imprisonment and a $5,000 fine. The review showed that in a prosecution for theft under the Penal Code, intent to steal must be shown and may be difficult to prove in a securities case; in a prosecution under the Securities Act, no such showing of intent to steal is required. However, with a significant number of cases being prosecuted which involve large sums of money, district attorneys who seek to obtain a stiffer penalty in such cases must turn to the Penal Code. The punishment under the Securities Act should be brought in line with the punishment for theft in the Penal Code so that a more appropriate penalty is provided for securities fraud where the amount of the transaction is $10,000 or more.

Procedures for Appealing Orders Denying Registration of Securities. Another area of concern identified in the review involves the procedures for review of orders of the commissioner denying registration of securities. Basic principles of due process require that any determination of legal rights and privileges be rendered by an impartial decision-maker, removed from investigation of the case. Review of the agency's process for appealing an order of the commissioner denying securities registration identified the potential for abuse of this principle. Under the current process, a recommendation to deny an application for registration made by the securities analyst assigned to the file, by the director of the securities registration division or by the deputy director must be reviewed by the commissioner. The commissioner makes the final decision to deny based on the staff's analysis of the application and information provided by the applicant. Under Section 24 of the Act, and rules and regulations promulgated by the board, any person or entity taking exception to the commissioner's denial of an application to register securities may apply for a hearing and request that the board preside in place of the commissioner. Agency rules provide that the board may deny the request, in which case the commissioner presides. Agency records show that the board has consented to hear an appeal of a denial order only twice in 22 years. The board's decision not to hear appeals of the commissioner's orders when requested results, in effect, in an aggrieved party appealing the commissioner's decision to the commissioner. Since the current procedures do not guarantee a party aggrieved by a denial order of the commissioner a review by an impartial body clearly removed from the original decision, as well as imposing unnecessary costs on both the agency and the applicant, the Securities Act and the agency's rules and regulations should be amended to provide an aggrieved applicant a right to a hearing before the board when requested.

Staffing Requirements. The review indicated that the agency cannot conduct a full investigation of every suspected violation of the Securities Act nor seek to apply sanctions to every violation of the Act. Due to its limited staff, the agency concentrates its enforcement efforts on violations involving fraud, and even among these cases, it must selectively pursue those in which the greatest harm has been inflicted on Texas investors and sanctions are reasonably obtainable. At the time of the review, the backlog of cases not being worked for lack of time and personnel totalled 312. In 76 of these cases, a formal investigation has been opened and the agency believes an indictment could be obtained if the investigation could be

actively pursued. In 246 of these cases, the agency has sufficient evidence of an actionable violation to justify further investigation. The agency indicated that these numbers represent an increase from previous years.

The State Securities Board has been successful in obtaining prosecution of securities violators in part because of the aid offered to district attorneys. In counties without specialized crime divisions familiar with securities cases, district attorneys without such experience may hesitate to pursue these cases without assurance of assistance from the agency. The agency identified a particular need for a staff "trial specialist" to provide assistance to local district attorneys in prosecuting securities violators. Additional staff for the enforcement division would reduce the backlog of cases not being worked for lack of time and personnel. The review indicated that the addition of a single investigator should result in approximately 70 additional investigations per year, based on the actual performance of four experienced investigators. The additional cost of one investigator is estimated to be $30,000 a year.

Appeals of Agency Orders. A final concern identified relates to the provision in the Act requiring review of agency orders in district court by "trial de novo." Under this standard of review, all testimony and evidence must be presented anew in district court, as if there had been no previous determination or hearing on the matters in controversy. This creates the potential for delays in the disposition of appeals, as well as additional time, effort and costs to the parties involved. The review indicated that the agency has been deterred from taking administrative action in certain cases where an appeal is likely because of the duplication of effort involved in presenting the case again in district court. Instead, to avoid this duplication, the agency will proceed directly to court by requesting the attorney general to bring a civil action, an often cumbersome and lengthy process. Removal of the "trial de novo" provision, thereby allowing use of the "substantial evidence" approach as set out in the Administrative Procedure Act would permit a court to review the record of a board hearing as a basis for a ruling. This change would help to expedite the disposition of appeals of board actions.

OTHER SUNSET CRITERIA

The review of the agency's efforts to comply with overall state policies concerning the manner in which the public is able to participate in the decisions of the agency and whether the agency is fair and impartial in dealing with its employees and the general public is based on criteria contained in the Sunset Act.

The analysis made under these criteria is intended to give answers to the following questions:

1. Does the agency have and use reasonable procedures to inform the public of its activities?
2. Has the agency complied with applicable requirements of both state and federal law concerning equal employment and the rights and privacy of individuals?
3. Has the agency and its officers complied with the regulations regarding conflict of interest?
4. Has the agency complied with the provisions of the Open Meetings and Open Records Act?

EVALUATION OF SUNSET CRITERIA

The material in this section evaluates the agency's efforts to comply with the general state policies developed to ensure: 1) the awareness and understanding necessary to have effective participation by all persons affected by the activities of the agency; and 2) that agency personnel are fair and impartial in their dealings with persons affected by the agency and that the agency deals with its employees in a fair and impartial manner.

Open Meetings/Open Records

The review indicated that the regulatory activities of the Securities Board have generally been undertaken in compliance with the Open Meetings Act. However, one concern was identified regarding a provision in the Securities Act which specifies that information filed by applicants for licensure as a securities dealer, investment advisor or their agents is considered confidential except for access by the courts or governmental agencies in the performance of official duties. The agency interprets this provision as exempting information contained in licensee files from the provisions of the Open Records Act.

The review of the licensing activities of the Securities Board revealed no compelling reasons for the records of these licensees to be treated differently from the same types of records of other licensing agencies. The special provision in this statute should be removed so that the licensing records of the Securities Board are open to the public on the same basis as records of other licensing agencies under the Open Records Act.

EEOC/Privacy

A review was made to determine the extent of compliance with applicable provisions of both state and federal statutes concerning affirmative action and the rights and privacy of individual employees. The Securities Board is operating under a current affirmative action plan which includes formal grievance procedures and personnel selection policies. The results of the review of these criteria indicated that the agency performs adequately in this area.

Public Participation

In general, the review of public participation consists of an evaluation of the extent to which persons served by the program and the general public have been informed of program activities and the extent to which the program is responsive

to the changing demands and needs of the public. The review showed that the general public is adequately represented on the board since all members are required to be citizens of the state who may not be licensed to sell or entitled to deal in securities. Public awareness is also encouraged through the issuance of news releases, the publication of a newsletter and agency participation in seminars concerning securities law.

Conflict of Interest

Under state law, appointed state officers are subject to statutory standards of conduct and conflict of interest provisions (Article 6252-9b, V.A.C.S.). This includes, in certain circumstances, the filing of financial disclosure statements with the Office of the Secretary of State. A review of the documents filed with the Secretary of State indicates that the three board members and the securities commissioner have filed adequate financial statements. In addition, the Securities Board has formally adopted policies regarding standards of conduct for members and employees of the board. All new employees and board members are provided with a copy of the board's policies and sign a statement that they have read the policies and intend to comply.

NEED TO CONTINUE AGENCY FUNCTIONS

AND

ALTERNATIVES

The analysis of the need to continue the functions of the agency and whether there are practical alternatives to either the functions or the organizational structure are based on criteria contained in the Sunset Act.

The analysis of need is directed toward the answers to the following questions:

1. Do the conditions which required state action still exist and are they serious enough to call for continued action on the part of the state?
2. Is the current organizational structure the only way to perform the functions?

The analysis of alternatives is directed toward the answers to the following questions:

1. Are there other suitable ways to perform the functions which are less restrictive or which can deliver the same type of service?
2. Are there other practical organizational approaches available through consolidation or reorganization?

NEED

The analysis of need and alternatives is divided into: 1) a general discussion of whether there is a continuing need for the functions performed and the organizational setting used to perform the functions; and 2) specific discussion of practical alternatives to the present method of performing the functions or the present organizational structure.

Functions

After reviewing the basic sunset questions relating to need for a function, it was determined that sufficient reason exists for the state to regulate the securities industry in Texas. The reasons for this determination can be summarized in the areas set out below.

Danger to the Public is Sufficient to Warrant Regulation. Occupations should be regulated by the state only when their unregulated practice can clearly harm or endanger the public and the public cannot be adequately protected by other means. In order to determine if there is a need to continue to regulate the securities industry in Texas an analysis was made of 1) whether the conditions that led to the regulation of the industry in 1923 still exist and 2) the possible harm to the public in the absence of regulation.

House Bill No. 177 enacted by the 38th Legislature in 1923 attributed the original need for regulation of the securities industry to the fact that the state had been flooded with worthless securities issued and sold by irresponsible parties resulting in great losses to investors. The continuing need to protect the public against fraudulent securities activities was seen again in 1955 when a new Securities Act and an Insurance Securities Act was enacted to protect the public from unscrupulous promotions in insurance securities characterized by high pressure sales to unsophisticated purchasers.

In attempting to determine the current need for the continuation of the regulation of the securities industry it was not possible to compare regulated states against unregulated ones since every state regulates the securities industry in some form. In the absence of this type of comparison an assessment of the continuing need and the potential harm to the public if there were no regulation of the industry was made by examining the abuses which the current activities of the agency prevent or address. Analysis of the agency's enforcement actions for the last four years indicates that 88 indictments have been returned, 63 convictions

obtained and 101 injunctions issued. Additional agency responses to industry irregularities include the issuance of 20 cease and desist orders, 20 cease publication orders, and 11 orders denying, revoking or suspending dealer or agent licenses. In addition, 316 applications for registration of securities valued at $255 million have been withdrawn or denied registration by the agency between 1979 and 1981.

Another possible indication of potential harm can be seen in the types of complaints investigated by the agency. Agency records show that more than 1,000 complaints are received annually. A review of the types of complaints filed indicates the agency investigates such problems as the promotion and sale of unregistered securities, fraudulent sales promotions, and sales by unregistered dealers.

The need for such actions demonstrates that Texas investors are still subject to abuses in the sale of securities. There is no reason to expect this harm to vanish or diminish in the absence of state regulation, and in fact, the potential for harm might be expected to increase due to the increasing volume of securities sold in this state, the growing complexity in the types of securities offerings being registered and the absence of the deterrent effect of regulation.

As set out above it would appear that the regulation of the securities industry is essential to protect the public. If regulation were to be continued, the review indicated that less restrictive methods of regulation than the current method exist. An analysis of the Securities Act shows that the current regulatory scheme is intended to be fairly restrictive. In general the Act regulates both the individuals engaged in the promotion and sale of securities and the securities themselves. The registration of securities requires that these issues be fair, just and equitable to the new investor. The board has established certain merit standards which these issues must meet in order to be registered in Texas. The Act requires that individuals seeking to be licensed as dealers or investment advisors and their agents meet certain requirements relating to financial condition, competency and character.

The regulation of the securities industry can be made less restrictive by modifying the regulation in several ways. The first alternative would require that securities issues meet only full-disclosure requirements rather than the more restrictive "fair, just and equitable" standards. Under this alternative the agency would ensure that all relevant information concerning an issue is disclosed but

would make no determination concerning the fairness or equity of the relationship between the investor and the issuer. A second regulatory alternative would eliminate the licensure of individuals acting only as investment advisors. This approach would eliminate regulation of individuals and their agents who only render investment advice and do not generally maintain a fiduciary relationship with their clients.

Agency

The review and analysis of the organizational structure indicated that an independent agency is the most efficient and effective means of carrying out securities regulation in Texas.

ALTERNATIVE APPROACHES FOR COMMISSION CONSIDERATION

Agency Reorganization

The State Securities Act is most appropriately administered by the State Securities Board. A survey of the organizations responsible for securities regulation in other states showed the three most prevalent alternatives to be an independent board or agencies like the Secretary of State and Attorney General. To assess the advantages and disadvantages of any other organizational alternative the review sought to determine if a consolidation or transfer of the functions would provide a significant number of the following benefits: 1) regulation would be more consistent and uniform; 2) the costs of administration of the function would be reduced; 3) utilization of existing personnel, equipment, supplies and office space would be improved; 4) regulation would be simplified by a reduction in the number of agencies serving a similar population; 5) access to a greater range of services and level of expertise would be provided; and 6) increased accountability would result. No organizational alternatives were identified where a transfer of the agency's function to another agency would result in achievement of a significant number of the benefits listed above.

Change in the Method of Regulation

Substitute Full-disclosure Requirements for the Current Merit Standards. The review identified two regulatory approaches which are used by the various states to regulate the issuance of securities. While the securities laws at the federal level and in a number of states were formulated to eliminate fraud by full-disclosure, Texas is one of 32 states which protect the public by imposing substantive standards designed to prevent insubstantial as well as fraudulent securities from being registered for sale in this state.

The Texas Securities Act currently requires that in order to register securities for sale in Texas they must be "fair, just and equitable." The rules and regulations promulgated by the board establish a number of guidelines concerning underwriting commissions, offering expenses, cheap stock, options and warrants, offering price, shareholder voting rights, debt and interest coverage, and promoters' investment which are used to determine whether the relationship between the issuer and the new investor is fair, just and equitable.

Published empirical studies evaluating the effectiveness of the application of merit standards in Texas and Wisconsin show that companies whose stock offerings

were approved for registration under the merit standards substantially outperformed the companies whose issues were denied or withdrawn in terms of price, book value, dividend distribution and cumulative total returns. In addition to evidence such as this, proponents of merit regulation also point to the difficulties created by the intangible nature of securities and the average investor's lack of the financial sophistication needed to fully understand the significance of the information disclosed in a typical prospectus. Another often-cited disadvantage of relying solely on the information disclosed in a prospectus is that in some instances prospectuses are not required to be furnished in advance of written confirmation of the sale or delivery of the securities.

The alternative to merit regulation is full-disclosure which requires that any individual or entity selling securities to the public disclose in its prospectus all material facts such as the financial standing of the issuer; the cash proceeds to be received by the issuer from the offering; the purposes for which the proceeds will be used; the capitalization and long term debt of the issuer; and the amount of underwriting and other sales expenses connected with the issue of securities. Proponents of this alternative argue that as long as state regulation assures that an investor is provided with enough data to make an intelligent and informed investment decision, the state need provide no greater degree of protection to the public. Other objections to the "merit" form of regulation center around 1) the difficulty in establishing formal rules which adequately define and quantify "merit" standards, thus hindering the objective and consistent application of the law; 2) the difficulty caused by the restrictiveness of the Texas Act as compared to other state acts in qualifying securities for sale, since the securities and capital markets are nationwide rather than statewide; and 3) the difficulty small businessmen and entrepreneurs seeking to raise capital in the public markets experience in qualifying under the "merit" standards.

While substituting full-disclosure requirements for the current merit standards would result in less protection to the public from the sale of insubstantial securities, benefits which would be derived include continued state regulation of the issuance of securities through a less restrictive method than currently available and anticipated increases in the number and types of securities sold in Texas.

Discontinue the Regulation of Investment Advisors and Their Agents. Investment advisors are individuals engaged in the business of advising others for a fee as to the value of securities or the desirability of buying or selling securities. This

advice may be rendered by publishing advisory services and periodic market reports for subscribers or by direct supervision of individuals' portfolios. The status of investment advisors under the Texas Securities Act is not clear: although investment advisors are included within the definition of a "dealer," there is no requirement in the Act that "dealers" register, only a prohibition that individuals may not sell, or offer for sale, securities if they are not registered. Since investment advisors do not ordinarily sell securities, there is some question whether they are currently required to register. The board has interpreted the Act to require registration of investment advisors and passed rules and regulations concerning record-keeping requirements.

This approach would eliminate any licensure of individuals whose sole function is to render investment advice for a fee. Although an investor may be harmed by the rendering of poor advice, since in practice an investment advisor does not generally hold a client's funds or securities, the review showed that the potential for harm is not as great as in the case of a dealer and therefore may not warrant state regulation.

A review of the licensing regulations in other states showed that only 25 states currently regulate investment advisors. Many of these individuals would continue to be recognized or regulated by the Securities and Exchange Commission or by voluntary professional organizations such as the Institute of Chartered Financial Analysts which recognizes individuals who demonstrate competence in the field of financial analysis. It is estimated that under this approach approximately 260 individuals doing business as an investment advisor would not be subject to an examination requirement or a criminal record check with the Department of Public Safety.

ACROSS-THE-BOARD RECOMMENDATIONS

STATE SECURITIES BOARD

Applied	Modified	Not Applied	Across-the-Board Recommendations
			A. ADMINISTRATION
X*			1. Require public membership on boards and commissions.
X			2. Require specific provisions relating to conflicts of interest.
X			3. A person registered as a lobbyist under Article 6252-9c, V.A.C.S., may not act as general counsel to the board or serve as a member of the board.
X			4. Appointment to the board shall be made without regard to race, creed, sex, religion, or national origin of the appointee.
X			5. Per diem to be set by legislative appropriation.
X			6. Specification of grounds for removal of a board member.
X			7. Board members shall attend at least one-half of the agency board meetings or it may be grounds for removal from the board.
X			8. The agency shall comply with the Open Meetings Act, and the Administrative Procedure and Texas Register Act.
X			9. Review of rules by appropriate standing committees.
X			10. The board shall make annual written reports to the governor and the legislature accounting for all receipts and disbursements made under its statute.
X			11. Require the board to establish skill oriented career ladders.
X			12. Require a system of merit pay based on documented employee performance.
X			13. The state auditor shall audit the financial transactions of the board during each fiscal period.
X			14. Provide for notification and information to the public concerning board activities.
	X		15. Require the legislative review of agency expenditures through the appropriation process.

*Already in statute.

State Securities Board
(Continued)

Applied	Modified	Not Applied	Across-the-Board Recommendations
			B. LICENSING
X			1. Require standard time frames for licensees who are delinquent in renewal of licenses.
X			2. A person taking an examination shall be notified of the results of the examination within a reasonable time of the testing date.
X			3. Provide an analysis, on request, to individuals failing the examination.
		X	4. (a) Authorize agencies to set fees.
X			(b) Authorize agencies to set fees up to a certain limit.
X			5. Require licensing disqualifications to be: 1) easily determined, and 2) currently existing conditions.
X			6. (a) Provide for licensing by endorsement rather than reciprocity.
		X	(b) Provide for licensing by reciprocity rather than endorsement.
X			7. Authorize the staggered renewal of licenses.
			C. ENFORCEMENT
X			1. Authorize agencies to use a full range of penalties.
X			2. Require files to be maintained on complaints.
X			3. Require that all parties to formal complaints be periodically informed in writing as to the status of the complaint.
X			4. Specification of board hearing requirements.
			D. PRACTICE
X			1. Revise restrictive rules or statutes to allow advertising and competitive bidding practices which are not deceptive or misleading.
X			2. The board shall adopt a system of voluntary continuing education.