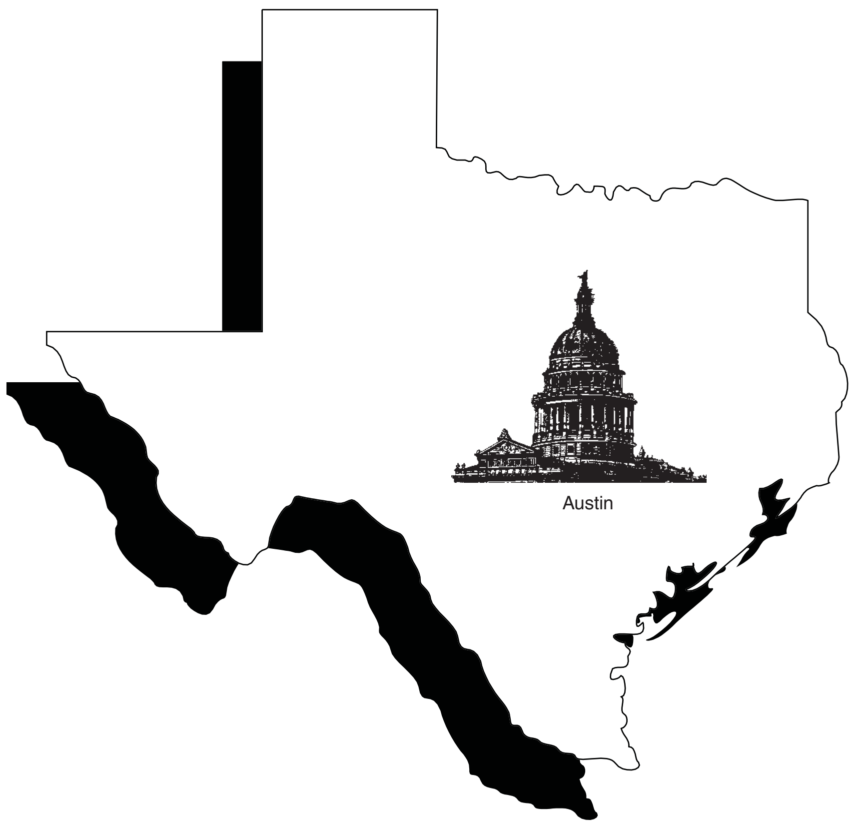
Sunset
Advisory Commission



State Securities Board

Staff Report

2000

SUNSET ADVISORY COMMISSION

Members

In 1977, the Texas Legislature created the Sunset Advisory Commission to identify and eliminate waste, duplication, and inefficiency in government agencies. The 10-member Commission is a legislative body that reviews the policies and programs of more than 150 government agencies every 12 years. The Commission questions the need for each agency, looks for potential duplication of other public services or programs, and considers new and innovative changes to improve each agency's operations and activities. The Commission seeks public input through hearings on every agency under Sunset review and recommends actions on each agency to the full Legislature. In most cases, agencies under Sunset review are automatically abolished unless legislation is enacted to continue them. This report is the Commission staff's recommendations, which serves as the starting point for the Commission's deliberations.

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Overview

The State Securities Board effectively carries out its mission, but additional changes would improve its ability to protect investors from securities fraud. The recommendations in this report would:

- enable more effective communication among Board members;
- add key enforcement tools, such as corporate criminal penalties, to the Securities Act;
- clarify the agency's ability to conduct unannounced inspections of securities dealers and investment advisers; and
- prevent fraud by directing the agency to educate investors.

Because protecting investors increases confidence in the securities market, improving the Board's ability to enforce the Securities Act would encourage more capital formation and job creation. The importance of these changes are highlighted by the fact that today more money is invested in Texas' securities market than is deposited in State banks, thrifts, and credit unions.

Issues / Recommendations

Issue 1 The Small Size of the State Securities Board Limits Its Effectiveness and Communication Among Its Members.

Key Recommendation

- Expand the State Securities Board from three to five public members.

Issue 2 The State Securities Board Lacks Certain Key Enforcement Tools Needed to Protect Texas Investors.

Key Recommendations

- Establish criminal liability against corporations for violations of the State Securities Act.
- Establish civil liability against investment advisers for fraud and registration violations.
- Extend the Commissioner's cease and desist authority to include unregistered agents and fraudulent sales practices, and authorize the Commissioner to issue emergency cease and desist orders.

Issue 3 State Law Does Not Specifically Authorize the State Securities Board to Perform Inspections.

Key Recommendations

- Specify that the State Securities Board has the authority to inspect securities dealers and investment advisers.
- Specify that information obtained through inspections is confidential and may not be disclosed to the public.

Issue 4 The State Securities Board Cannot Effectively Protect Investors Without Educating Them About Fraud.

Key Recommendations

- Specify in the Securities Act that investor education is a function of the State Securities Board.
- Grant the State Securities Board statutory authority to accept gifts, grants, and donations for use in educating investors.
- Require the State Securities Board to maintain a toll-free number and collaborate with the National Fraud Complaint Management Center to handle investors' questions and complaints.
- Require the State Securities Board to maintain an e-mail address on its Web site to specifically handle questions and requests for documentation from investors and securities professionals.

Issue 5 Unlike Federal and Other States' Statutes, Texas Law Fails to Distinguish Between Securities Dealers and Investment Advisers.

Key Recommendation

- Define securities dealers, investment advisers, and their agents separately in the Securities Act.

Issue 6 Texas Has a Continuing Need for the State Securities Board.

Key Recommendation

- Continue the State Securites Board for 12 years.

Fiscal Implication Summary

This report contains recommendations that will have a fiscal impact to the State. These recommendations are discussed below, followed by a five-year summary chart.

- Issue 1 - Expanding the State Securities Board to five members would result in additional travel expenses and per diem of two new members costing the State about $1,800 a year.
- Issue 4 - An investor education program would cost the State about $77,500 per year to pay for the program's operating expenses and one full-time employee to manage the program.

Fiscal Year	Cost to the General Revenue Fund	Change in FTEs in FY 2001
2002	$79,300	+1
2003	$79,300	+1
2004	$79,300	+1
2005	$79,300	+1
2006	$79,300	+1

Issues / Recommendations

Issue 1

The Small Size of the State Securities Board Limits Its Effectiveness and Communication Among Its Members.

Summary

Key Recommendation

- Expand the State Securities Board from three to five public members.

Key Findings

- The small size of the State Securities Board limits its effectiveness and internal communication.
- The Legislature has acted to create state agency governing bodies of an adequate size.

Conclusion

The work of the State Securities Board in regulating the Texas securities market is hampered by its small size. As a three-member policy body, members of the Board cannot informally discuss the work of the agency without violating the Open Meetings Act. The Board also cannot form subcommittees to help it oversee the agency. In view of these problems, the Legislature has acted to form larger policy bodies for the majority of state agencies; has increased the size of other three-member boards; and, with voter approval, has recently amended the Constitution to allow greater flexibility in creating agency boards. The Sunset review examined the work of the Securities Board and concluded that the addition of more members would allow it to operate more effectively.

Support

<u>Current Situation:</u> The State Securities Board is a three-member governing body.

- In 1957 the Legislature created the State Securities Board as a three-member body appointed by the Governor.
- The Board, which usually meets three times a year and is composed of all public members, employs the Securities Commissioner, passes rules to enforce the Securities Act, and hears appeals from parties who object to decisions of the Commissioner.

<u>Problem:</u> The small size of the State Securities Board limits its effectiveness and internal communication.

Three-member boards violate the Open Meetings Act anytime two members discuss agency business without advance posting.

- The Texas Open Meetings Act presents difficult communication challenges for three-member boards. Because a meeting occurs any time a quorum discusses public business, three-member boards violate the Act whenever two members discuss the agency's work without advance posting. Under the terms of the Open Meetings Act, members of the State Securities Board cannot informally discuss the work of the agency or directly talk with each other.
- The small size of the Board also limits its use of subcommittees as a tool in overseeing the agency. While the Board could create two-member subcommittees, it cannot have two subcommittees simultaneously working on different issues — a primary benefit of subcommittees. The current size of the Board also limits the benefit of using subcommittees to divide the Board's workload. Although Board members may individually discuss matters with agency personnel, this option does not provide the difference of opinions that would come from having a subcommittee with members.
- Members of the State Securities Board have also commented that the expertise of the Board could be enhanced by adding members. This expertise would not require the addition of industry members, but could come from adding public members with knowledge of the securities industry.

<u>Comparison:</u> The Legislature has acted to create state agency governing bodies of an adequate size.

- Most other state agency policy bodies have more than three members. Of 111 boards or commissions appointed by the Governor, only nine consist of three members, and three of those nine have members who serve full-time.[1]

- The Legislature has acted to increase the size of state boards when doing so would allow more effective oversight. For example, in 1991, the Legislature acted on a recommendation from the Sunset Commission to increase the size of the governing board of the State Purchasing and General Services Commission from three to six members. In making the recommendation, the Sunset Commission pointed out that a larger board would avoid conflicts with the Open Meetings Act and would allow for the use of subcommittees.[2]
- In 1999, the Legislature requested Texas voters to approve a constitutional amendment giving greater flexibility to the Legislature to create boards with an odd number of members, such as boards with five or seven members. The amendment, which voters approved, provides that boards must be composed of an odd number of members *as nearly* divisible by three as possible.

Recommendation

Change in Statute

1.1 Expand the State Securities Board from three to five public members.

Impact

This recommendation would expand the State Securities Board to avoid problems with the Open Meetings Act, increase the Board's ability to communicate, allow the use of subcommittees, and increase its expertise. Expanding the Board's membership to five members keeps it within the structure of the recent constitutional amendment.

Fiscal Implication

This recommendation would have a fiscal impact to the State. Expanding the Board would result in additional travel expenses and per diem of two new Board members. Based on current projections, costs would increase by about $1,800 per year.

Fiscal Year	Cost to the General Revenue Fund
2002	$1,800
2003	$1,800
2004	$1,800
2005	$1,800
2006	$1,800

[1] The Texas Natural Resource Conservation Commission, Public Utility Commission, and Workforce Commission are the three full-time commissions with three members each. The part-time three-member boards or commissions with gubernatorial appointments are the Alcoholic Beverage Commission, Lottery Commission, Department of Public Safety, State Securities Board, Texas Department of Transportation, and the Veteran's Land Board.

[2] Sunset Advisory Commission, *Final Report*, March 1991, p. 153.

Issue 2

The State Securities Board Lacks Certain Key Enforcement Tools Needed to Protect Texas Investors.

Summary

Key Recommendations

- Establish criminal liability against corporations for violations of the State Securities Act.
- Establish civil liability against investment advisers for fraud and registration violations.
- Extend the Commissioner's cease and desist authority to include unregistered agents and fraudulent sales practices, and authorize the Commissioner to issue emergency cease and desist orders.

Key Findings

- In a rapidly growing market, the State Securities Board aggressively enforces the Securities Act to protect Texas investors from fraud.
- Texas cannot bring criminal charges against businesses or corporations for securities violations and fraud.
- The Securities Act does not hold investment advisers, unlike securities dealers, civilly liable for fraudulent activity and securities violations.
- The State Securities Board lacks cease and desist authority against unregistered agents of securities dealers and investment advisers, and fraudulent sales practices.
- The State Securities Board's ability to effectively use cease and desist orders to protect investors from fraud is severely limited because orders can take five to nine months to become effective.

Conclusion

The State Securities Board primarily achieves its mission of protecting investors by enforcing the Securities Act. However, the State Securities Board lacks certain key enforcement tools needed to further deter and redress fraud and securities violations. These recommendations would further the Securities Act objective to protect investors by providing for the prosecution of criminal enterprises, allowing investors to recover losses due to an investment adviser's illegal activities, and enabling the Commissioner to more quickly stop fraud and securities violations.

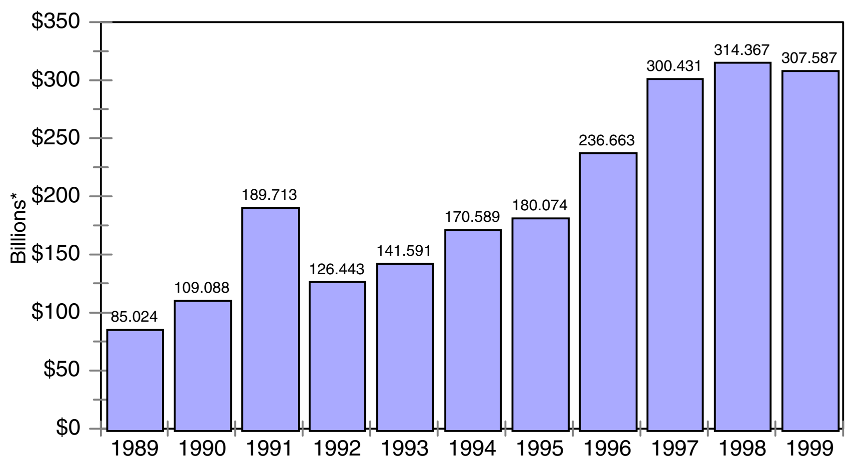
Support

In 1999, Texas' $307 billion securities market exceeded deposits in the state's financial institutions by $85 billion.

<u>Current Situation:</u> In a rapidly growing market, the State Securities Board aggressively enforces the Securities Act to protect Texas investors from fraud.

- The Texas securities market has grown dramatically to become one of the largest in the nation. The figure, *Texas Securities Market: 1989 to 1999,* shows that the dollar volume of securities applications and filings processed by SSB tripled from $85 billion in 1989 to more than $307 billion in 1999.[1] The securities market has also grown to exceed deposits in Texas' banks, savings and loans, savings banks, and credit unions. Indeed, the dollar volume of securities applications processed in Texas exceeded the combined deposits in the state's financial institutions by $29 billion in 1996, and by $85 billion in 1999.[2] Without aggressive enforcement, Texas' large and rapidly growing capital market and population of investors could be an attractive target for fraudulent schemes.

Texas Securities Market
1989 to 1999



***Total Dollar Volume of Securities Applications and Filings Processed**

- The primary mission of the State Securities Board (SSB) is to protect Texas investors. SSB uses three important enforcement tools to achieve its mission: criminal, civil, and administrative penalties. The agency cooperates extensively with district and U.S. attorneys to try criminal cases, and with the Texas Attorney General's Office to obtain civil actions. SSB's enforcement authority is designed to prevent and redress fraudulent sales of securities and violations of the Securities Act, such as illegal sales of unregistered securities, and sales of securities by unregistered dealers. Through enforcement actions, the agency ensures a free and competitive securities market, increases investor confidence, and thereby encourages the formation of capital.

- The State Securities Board aggressively enforces the Securities Act. The table, *SSB's Enforcement Actions — 1999,* highlights the agency's recent enforcement actions.[3] For several years, Texas has initiated more criminal proceedings and obtained more criminal convictions than any other securities regulatory agency in the nation. In 1999, prison sentences for fraudulent securities activities ranged from probation to 25 years. During the same year, SSB helped secure restitution of about $13.1 million to investors, and obtained more than $400,000 in administrative fines for securities violations.[4]

SSB's Enforcement Actions — 1999

	Securities Dealers	Investment Advisers	Total
Criminal Convictions	82	3	85
Transactions Indicted	108	33	141
Civil Actions	71	0	71
Administrative Orders	151	27	178

<u>Problem:</u> Texas cannot bring criminal charges against businesses or corporations for securities violations and fraud.

- The State Securities Board can seek criminal charges against individuals, but not businesses, for fraud and violations of the Securities Act. Because fraudulent businesses may hire new employees to perpetuate a fraud, pursuing individuals alone may be ineffective. Additionally, business dissolution is often the most appropriate course of action for fraudulent companies with connections to organized crime. Although Texas has not yet faced these problems, other states have recently brought criminal actions against firms with suspected ties to organized crime.[5]

- Under the Texas Penal Code, prosecutors can bring criminal charges against businesses for theft. However, Texas remains the only state that does not have corporate criminal penalties for violations of securities laws. Consequently, Texas' lower standard on criminal penalties may create a "race to the bottom" by inviting fraudulent securities businesses to the state. The table, *A Brief History of Corporate Criminal Penalties,* may provide some explanations as to why the Securities Act still restricts criminal penalties to natural persons in Texas.

- Administrative penalties may be ineffective in redressing fraud and securities violations since businesses may choose to ignore these sanctions. For example, a firm may decide to keep operating without a license and ignore the threat of a fine.

A Brief History of Corporate Criminal Penalties

In 1971, the Texas Legislature amended the Securities Act to clarify that most penalties against individuals also apply to business entities. Because the Penal Code, at that time, did not allow criminal penalties against business entities, legislators did not include criminal penalties against corporations in amending the Securities Act. In 1974, the Penal Code and the Code of Criminal Procedure were amended to allow criminal penalties against business entities. However, the Securities Act has not been revised to include corporate criminal penalties.

<u>Problem:</u> The Securities Act does not hold investment advisers, unlike securities dealers, civilly liable for fraudulent activity and securities violations.

- The State Securities Board regulates both securities dealers and investment advisers. Whereas securities dealers offer and sell securities, investment advisers offer advice, recommendations, or analysis on securities, and may provide continuous portfolio management. Because of their ability to influence investors, fiduciary risks such as conflicts of interest are generally considered higher for investment advisers than for securities dealers. Despite the risk of financial loss associated with fraudulent advice, the Securities Act does not hold investment advisers, unlike securities dealers, civilly liable. Consequently, defrauded investors in Texas cannot recover funds lost due to an investment adviser's fraudulent or unregistered activity, unlike their ability to do so for securities dealers.

Texas, unlike 28 other states, does not hold investment advisers civilly liable for fraud or securities violations.

- Under the Texas Deceptive Trade Practices Act, investors can sue investment advisers who engage in deceptive practices. But Texas, unlike 28 other states, does not hold investment advisers civilly liable in its securities statute for fraud or securities violations.
- In 1999, SSB was instrumental in securing restitution or recission to investors of more than $13.1 million. During the same year, Texas convicted three investment advisers of criminal charges and obtained indictments for 33 transactions performed by unregistered investment advisers. Had investment advisers been civilly liable, investors may have been able to recover fees paid to these unregistered individuals, and attempted to recover financial losses associated with fraudulent transactions.

<u>Problem:</u> The State Securities Board lacks cease and desist authority against unregistered agents of securities dealers and investment advisers, and fraudulent sales practices.

- The Securities Commissioner may use cease and desist orders to prohibit unregistered individuals or firms from acting as securities dealers or investment advisers; prohibit or suspend the sale of securities; deny or revoke the registration of securities; and prohibit the publication of securities offerings.
- The Commissioner does not have the authority to cease and desist the activities of "unregistered" agents of securities dealers and investment advisers. As defined in the Securities Act, agents include individuals and companies employed, appointed or authorized by an investment adviser or a securities dealer to sell or give advice on their behalf respectively. Agents represent the largest percentage of registrants in Texas. In 1999, more than 157,000 agents

represented almost 97 percent of the total registrations of securities dealers and investment advisers in Texas. Because agents perform the same functions as investment advisers and/or securities dealers, their "unregistered" activities should be subject to the same cease and desist authority as "unregistered" securities dealers and investment advisers.

- The Commissioner's cease and desist authority regarding the sale of securities extends only to particular securities named in the cease and desist order, and not to the underlying fraudulent conduct. Because securities issuers, dealers, and agents can easily discontinue one offering and initiate another similar but legally distinct offering, cease and desist authority should prohibit the fraudulent means by which securities are offered for sale or sold.

SSB cannot order unregistered agents to cease their activities when necessary.

Problem: **The State Securities Board's ability to effectively use cease and desist orders to protect investors from fraud is severely limited because orders can take several months to become effective.**

- The State Securities Board lacks emergency cease and desist authority which would allow the agency to immediately stop any act or practice harming investors. Currently, the Commissioner's cease and desist orders only go into effect after an administrative law judge has held a hearing determining the validity of the order. Because this process may last more than a year, investors may be harmed by unknowingly investing in fraudulent securities against which an order is pending.
- At least 36 state securities regulatory authorities, the U.S. Securities and Exchange Commission (SEC), and other Texas regulatory agencies, such as the Department of Banking and the Texas Racing Commission, have authority similar to emergency cease and desist orders.

Recommendation

Change in Statute

2.1 Establish criminal liability against corporations for violations of the State Securities Act.

This recommendation would extend the Securities Act's criminal penalties to include business entities that engage in fraud or violate registration provisions. Convicted businesses would be subject to sanctions set forth in the Texas Penal Code and the Business Corporations Act. To prevent corporations from being subject to criminal penalties for the actions of a few individuals, the statute would create an affirmative defense to prosecution: the fact that a high managerial agent of the entity, with supervisory responsibility over the subject matter of the offense, employed due diligence to prevent commission of the offense.

2.2 Establish civil liability against investment advisers for fraud and registration violations.

This change would extend civil liability provisions for securities dealers in the Securities Act to include investment advisers engaging in fraud or violating registration provisions. A person or a firm would not be liable if either the client knew of the untruth or omission, or the investment adviser did not know, and, in the exercise of reasonable care, could not have known of the untruth or omission. A person or a firm who directly or indirectly controls the investment adviser would be liable to the same extent as the investment adviser, unless the controlling person did not know of the facts. Consistent with current civil liability provisions for securities dealers, the statute would place a three-year limitation on registration violations, and a five-year limitation on fraud.

2.3 Extend the Commissioner's cease and desist authority to include unregistered agents and fraudulent sales practices, and authorize the Commissioner to issue emergency cease and desist orders.

This recommendation would extend the Commissioner's cease and desist authority to include unregistered agents of securities dealers and investment advisers, and the fraudulent sale practices in which a firm or individual has engaged or is about to engage. This change would also authorize the Securities Commissioner to issue emergency cease and desist orders to immediately stop any fraud, fraudulent activity, or violation of the Securities Act. These orders would be limited to situations presenting an immediate threat to the public welfare, including the sale of non-exempt unregistered securities and the unregistered activities of securities dealers, investment advisers and their agents. Emergency cease and desist orders would supplement, and not replace, the Commissioner's regular cease and desist authority.

An individual or firm served with an emergency cease and desist order would be able to file a request for hearing within 30 days of service of the order. Within 10 days after the receipt of such a request, the Commissioner would issue a notice of hearing to be held before a hearings officer in accordance with the Administrative Procedure Act to recommend whether the order should be modified, vacated, or upheld, and to consider such other matters set forth in the notice of hearing. At the hearing, the Commissioner would have the burden of proof and would be required to present evidence in support of the order. An emergency cease and desist order would continue in effect unless the order is stayed by the Commissioner.

Impact

Additional enforcement authority would enable the State Securities Board to respond more appropriately to violations of the Securities Act, add further deterrence to violations, and thereby further the agency's mission of protecting investors.

The recommendation on corporate criminal penalties would subject a convicted business entity to greater fines (up to double the amount gained or caused to be lost by the entity, whichever is greater), disclosure of the conviction to any person the court deems appropriate, and notification to the Attorney General who may bring civil proceedings to dissolve the corporation.

The recommendation to extend civil liability to investment advisers would add further deterrence to fraud. In addition, investors would be able to recover funds lost due to an investment adviser's fraudulent activities, similar to the ability to recover funds from a securities dealer's illegal activities.

The recommendation to strengthen the Commissioner's cease and desist authority would allow SSB to respond more quickly and appropriately to securities violations and fraud.

Fiscal Implication

These recommendations would have no fiscal impact to the State. However, fines collected from businesses and corporations convicted of criminal charges would be a gain to the counties in which the prosecutions take place.

[1] These numbers represent only a fraction of the total volume of securities transactions in Texas. Most transactions are made pursuant to exemptions from registration in the Securities Act because certain securities and transactions have sufficient safeguards in place to protect the public without the necessity of registration. A full analysis of the growth in the Texas securities market would require analysis of all transactions made by Texans or Texas companies including those on stock exchanges, in private placements, in secondary trading transactions, in issuer transactions with existing securities holders, and in institutional and venture capital financing transactions.

[2] State Securities Board, "Supplement to the Annual Report August 31, 1999." Online. Available: http://www.ssb.state.tx.us/99APSUP.html. Accessed: August 22, 2000.

[3] Ibid.

[4] Ibid.

[5] U.S. Congress, House Commerce Committee Subcommittee on Finance and Hazardous Materials, "Organized Crime on Wall Street," testimony by Bradley W. Skolnik, Indiana Securities Commissioner and President of the North American Securities Administrators Association, Inc., September 13, 2000.

Issue 3

State Law Does Not Specifically Authorize the State Securities Board to Perform Inspections.

Summary

Key Recommendations

- Specify that the State Securities Board has the authority to inspect securities dealers and investment advisers.
- Specify that information obtained through inspections is confidential and may not be disclosed to the public.

Key Findings

- Inspections are a critical and long-standing component of the State Securities Board's regulation of securities dealers and investment advisers.
- The Securities Act gives the agency broad regulatory authority, but does not specifically address inspections or the confidentiality of information obtained through inspections.
- The State Securities Board's authority to do inspections, and the confidentiality of records obtained, has been challenged in court.
- Federal and other states' statutes specifically provide for inspection authority and confidentiality of inspected records.

Conclusion

The Securities Act is unspecific with regard to the State Securities Board's inspection authority and does not provide for the confidentiality of inspected records. This lack of specificity has led to an appeal in a state district court challenging the Commissioner's sanction of a company as well as the State Securities Board's authority to inspect securities dealers and investment advisers. The Sunset review concluded that the Securities Act should be clarified to specifically provide for unannounced inspections authority, and the confidentiality of inspected records.

Support

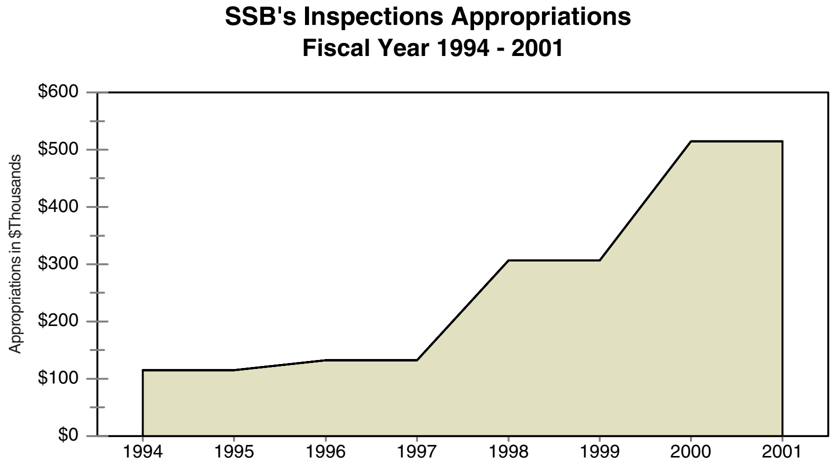
<u>Current Situation:</u> Inspections are a critical and long-standing component of the State Securities Board's regulation of securities dealers and investment advisers.

- The State Securities Board (SSB) registers and inspects securities dealers and investment advisers under its jurisdiction. In 1999, SSB registered about 5,000 firms and individuals subject to inspections. The agency began its inspection program in FY 1990 to respond to the significant growth of the securities industry and ensure compliance with the Securities Act and Board rules.

  For investment advisers with less than $25 million in assets under management, SSB is the only regulatory entity doing inspections. For securities dealers, SSB coordinates quarterly with the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) to do inspections. On average, the State Securities Board inspects the offices of securities dealers and investment advisers, which are not regularly inspected by other regulatory authorities, every eight years.

SSB inspections are geared towards the detection of sales practice abuses, fraud, and unregistered activity.

- SSB's inspections of securities dealers and investment advisers are geared toward the detection of sales practice abuses and are mostly conducted without prior notice. Inspectors verify that complaint files and other records are well maintained, that information provided in the registration forms is accurate, and that no fraudulent or unregistered activity occurs. Inspected information is sometimes shared with other regulatory entities such as SEC and NASD. The State Securities Board holds that information obtained through inspections is confidential and neither the agency nor any other regulatory entity sharing this information may release it publicly.
- The Legislature has shown an increasing interest in SSB's inspections of securities dealers and investment advisers. The figure, *SSB's Inspections Appropriations, Fiscal Year 1994-2001*, shows the increased funding the Legislature has allocated for SSB's inspections. In FY 1999, SSB's inspections comprised about 14 percent of the agency's total budget of $3.7 million. That year, the agency performed 164 inspections resulting in the detection of 45 individuals or firms not complying with the Securities Act or Board rules, and the referral of seven cases to enforcement.



Problem: The Securities Act gives the agency broad regulatory authority, but does not specifically address inspections or the confidentiality of information obtained through inspections.

- The Texas Attorney General recently issued a legal opinion challenging a state agency's inspection authority because it was based on the Board's authority to develop rules to ensure compliance with its statute. The opinion further argued that even if the permissibility of warrantless inspections could be inferred from the Board's rulemaking authority, the provision of the rule would not meet constitutional requirements because it lacked a properly defined scope, and did not limit the discretion of inspectors.[1]

- In parallel, the Securities Act does not specifically state that SSB may conduct inspections of securities dealers and investment advisers. The Act refers to SSB's investigation authority and allows the agency to take measures to prevent or detect violations of the Securities Act, and to adopt the necessary rules to carry out and implement provisions of the Act. Based on this authority, SSB adopted a rule allowing the agency to perform unannounced examinations. However, this rule does not define the scope of the agency's inspection authority. The table, *SSB's Inspection Authority*, describes the legal basis for the agency's inspections.

- The Securities Act does not provide that information obtained from SSB's inspections is confidential and exempt from public disclosure. Yet, inspected records contain information about securities dealers, investment advisers, and their clients that could be misused by the public. For example, such records

SSB's Inspection Authority

The State Securities Board derives its inspection authority from Section 3 and Section 28-1 of the Securities Act that require the Commissioner to ensure that the provisions of the Act "are at all times obeyed and to take such measures and to make such investigations as will prevent or detect the violation of any provision thereof" and grant the Board the authority to adopt " such rules as may be necessary to carry out and implement" provisions of the Act. Consistent with the Act, the Board adopted rule 115.7 which allows it to conduct unannounced on-site examinations. In addition, before registering with SSB, securities dealers and investment advisers have to sign form 133.16, which is an agreement for maintenance and inspection of records.

include the names of clients and the amount they invested in particular funds or securities. As a result, the lack of specificity in the Securities Act may subject SSB inspected records to public disclosure.

With the recent passage of the federal Gramm-Leach-Bliley Act (GLBA) authorizing the consolidation of banks, securities firms, and insurance companies, information from SSB's inspections is expected to be increasingly shared with other regulatory entities, such as the Texas Department of Banking or the Texas Department of Insurance. Indeed, because GLBA preserves the functional regulation of these consolidated financial companies, the sharing of information between agencies will need to increase to avoid duplication. The lack of expressed confidentiality of inspected records in the Securities Act may make it difficult for state agencies to keep this information confidential.

Problem: The State Securities Board's authority to do inspections, and the confidentiality of records obtained, has been challenged in court.

- Although the State Securities Board maintains that it can do inspections, and that information from inspections is confidential, the legal basis to support the confidentiality of such records is uncertain. Concerns over the confidentiality of inspected records are allegedly at the origin of a state district court case appealing the Commissioner's sanctions against a company for refusing to disclose information during an unannounced inspection. During this case, lawyers have used the Securities Act's lack of specificity to argue that SSB does not have the authority to perform inspections. A decision on this case is pending.

Comparison: Federal and other states' statutes specifically provide for inspection authority and the confidentiality of inspected records.

- The Securities and Exchange Commission (SEC) and 48 other state securities statutes more specifically provide for the securities regulatory agency's inspection or examination authority.
- SEC and at least 26 other states' securities statutes specifically provide for the confidentiality of part or all records obtained from investigations, examinations, or inspections.

Recommendation

Change in Statute

3.1 Specify that the State Securities Board has the authority to inspect securities dealers and investment advisers.

This recommendation would authorize the Commissioner to conduct, without notice, an inspection of the records of a securities dealer or an investment adviser, at any office of the dealer or investment adviser during regular business hours, for the purpose of ensuring compliance with the Securities Act and Board rules. During such inspections, the Commissioner would have immediate and free access to such records, and to all locations where such records are kept by the dealer or investment adviser. During the inspection, the Commissioner would be permitted to make photostatic or electronic copies of such records without charge to the Commissioner.

3.2 Specify that information obtained through inspections is confidential and may not be disclosed to the public.

This recommendation would provide for the confidentiality of information obtained in the inspection of the records of a dealer or investment adviser, in accordance with the requirements of Section 28 of the Securities Act. The confidentiality would extend to internal notes, memoranda, reports, and communications made in connection with the inspection. However, an order of court would subject all information to public disclosure.

Impact

These recommendations would reduce the extent to which the Act is subject to interpretation and ensure that inspected records remain confidential. These changes will not affect the operations of the State Securities Board but should help it avoid future legal challenges to its authority.

Fiscal Implication

These recommendations would not have a fiscal impact to the State.

[1] Texas Attorney General Opinion No. JC-0274, (August 29, 2000).

Issue 4

The State Securities Board Cannot Effectively Protect Investors Without Educating Them About Fraud.

Summary

Key Recommendations

- Specify in the Securities Act that investor education is a function of the State Securities Board.
- Grant the State Securities Board statutory authority to accept gifts, grants, and donations for use in educating investors.
- Require the State Securities Board to maintain a toll-free number and collaborate with the National Fraud Complaint Management Center to handle investors' questions and complaints.
- Require the State Securities Board to maintain an e-mail address on its Web site to specifically handle questions and requests for documentation from investors and securities professionals.

Key Findings

- In addition to well-recognized enforcement efforts to correct the occurrence of fraud, the State Securities Board is actively engaged in fraud prevention.
- Increasing numbers of novice investors entering the securities market are at risk from fraudulent schemes.
- The State Securities Board cannot effectively protect investors without educating them about fraud.
- The State Securities Board's education program is hampered by a lack of statutory authority.
- The lack of access to the State Securities Board undermines the agency's outreach efforts towards investors.

Conclusion

Although half of the American population is investing in the securities market, most investors know little about the basics of investing and fraud. As a result, investors are defrauded of millions of dollars each year by unscrupulous securities dealers and investment advisers. Although education is a key to achieving the agency's mission of protecting investors, the State Securities Board is not statutorily directed to educate investors and accept donations for this purpose. Consequently, the State Securities Board's education efforts have been significantly limited by a lack of resources, and current efforts are absorbed by staff and funds from other programs. These recommendations would enable the State Securities Board to better protect investors by educating them about fraud and the basics of effective investing.

Support

Current Situation: In addition to well-recognized enforcement efforts to correct the occurrence of fraud, the State Securities Board is actively engaged in fraud prevention.

- The State Securities Board's (SSB) prevention efforts focus on ensuring that securities professionals are qualified and comply with the law, and that securities offerings are "fair, just, and equitable" to prospective investors. For these purposes, SSB registers securities offerings and securities professionals in Texas, and inspects individuals and firms selling securities or rendering investment advice. In 1999, SSB processed 26,811 securities applications and filings, registered 162,854 securities professionals, and conducted 164 inspections. These prevention efforts comprised about 38 percent of the agency's budget that year.
- The State Securities Board also engages in educational efforts through the issuance of investor alerts and press releases describing recent enforcement actions, and the distribution of financial planning guides to Texas families. In addition, a current appropriation rider to the agency's budget permits SSB to accept donations for the purpose of reproducing and distributing personal financial literacy materials to classroom teachers in Texas. As part of this function, SSB distributes, free of charge, a teaching guide on the basics of saving and investing to school teachers across Texas.

Problem: Increasing numbers of novice investors entering the securities market are at risk from fraudulent schemes.

- Texas investments have greatly increased over the past ten years. The total dollar volume of securities applications tripled in 10 years to reach more than $307 billion in 1999. In addition, Texans are increasingly transforming potential savings into investments. The dollar volume of processed securities applications exceeded deposits in all financial institutions, such as Texas banks, savings banks, and credit unions, by $29 billion in 1996, and by $85 billion in 1999. The number of investors is likely to continue increasing due to proposed Social Security reforms permitting individuals to invest a part of their retirement fund, a decline in the number of defined benefit retirement plans, and technological advances making access to information and trading systems fast and easy.

Fifty percent of Americans are investing in the securities market, but many know little about investing.

- Experts estimate that more than half of the American population invests in the securities market.[1] However, studies show that Americans know little about investing. For example, a survey and focus groups, commissioned in 1997 by the National Association of Securities Dealers, showed that only 12 percent of adult respondents knew the difference between a "load" and "no-load" mutual fund, a basic investment concept.[2] Additional studies show that lack of knowledge about personal finances is seriously lacking among high school students. A nationwide survey conducted by the Jump$tart Coalition for Personal Financial Literacy found that only 23 percent of the more than 1,500 high-school students surveyed correctly identified stocks as the most likely financial instrument to have the highest return.[3]

- Financially undereducated investors are prone to become the victims of fraudulent securities schemes. The table, *Most Frequent Investment Frauds*, shows the most common ways unscrupulous securities dealers and investment advisers defraud investors of millions each year.

- In FY 1999, the dollar amount of fraud prosecuted in Texas totaled more than $18 million. The State Securities Board expects this number to be as high as $70 million in FY 2000. Unfortunately, the State is rarely able to secure the restitution of funds to investors. In FY 1999, Texas was successful in securing the restitution of more than $13 million to investors, but many other millions were lost to investors.

Most Frequent Investment Frauds

1	Affinity Group Fraud: fraud on religious, ethnic or professional groups by members of these groups or persons claiming to want to help these groups
2	Internet Fraud: includes market manipulation, insider trading, and unlicensed activity
3	Abusive Sales Practices: sales of securities to unsuitable investors, fraudulent offerings, and market manipulation
4	Investment Seminars: include unlicensed activity, lack of disclosure of conflicts of interests, and hidden fees and commissions
5	Telemarketing Fraud: nationwide, hundreds of "boiler rooms," or high pressure telephone sales operations that disseminate illegal or fraudulent investment products
6	Deceptive Marketing of Municipal Bonds: risky bonds secured by over-valued real estate being marketed as "safe" general obligation bonds
7	Unregistered Immigration Investments: investments that allegedly would confer "alien immigration status" on foreign nationals seeking to immigrate to the US
8	Illegal Franchise Offerings: inadequate disclosure and fraud in connection with the offering of franchise investments, often through business opportunity and franchise shows
9	High-Tech Products and Services: misleading or illegal offerings of high-tech investments that target unsophisticated investors with promises of high profits and minimal risk in such areas as 900 numbers or the Internet
10	Entertainment: scams offering opportunities for investments in movie deals and other entertainment products with promises of guaranteed profits that minimize or ignore risks

Source: North American Securities Administrators Association, Inc. "State Securities Identify 'Top Ten Frauds.'" Online. Available at: Accessed: September 05, 2000.

<u>Problem:</u> The State Securities Board cannot effectively protect investors without educating them about fraud.

- SSB cannot prevent fraud and securities violations through registrations and inspections alone. Most fraudulent securities offerings and securities professionals cannot be detected through the registration process, and securities dealers and investment advisers may not be inspected for several years in a row. In FY 1999, SSB inspected fewer than 4 percent of securities dealers and advisers subject to inspections. In addition, investment advisers managing less than $25 million in assets in Texas can expect to be inspected only once every eight years.

- Investors need to be educated about fraudulent securities schemes to avoid entering into them. Informed investors would know to contact the agency to check the registration status of securities professionals and securities offerings, and inquire about the legality of particular sales practice. In addition, educated investors would be more likely to make better investment decisions in planning for retirement and potentially investing social security money.

<u>Problem:</u> The State Securities Board's education program is hampered by a lack of statutory authority.

- Although SSB's mission is to protect investors, the agency is not statutorily directed to educate investors. Yet, without clear statutory guidance, SSB lacks the authority to further expand its efforts to educate investors. For example, during the last legislative session, the agency requested, but did not receive, $78,000 to fund its education program. Consequently, SSB's investor education efforts have been significantly limited by a lack of resources, and current efforts are absorbed by staff and funds from other programs.
- During the last legislative session, SSB did receive the authority to solicit funds from non-profit organizations for the limited purpose of distributing teaching materials to high school teachers in Texas. However, authorizing donations for this specific purpose prevents many donors from contributing to the agency's education program. As of September 2000, SSB has not yet received any donations.
- Additionally, even if SSB were to receive donations, Government Code provisions may prevent the agency from accepting them because it lacks specific statutory authority to accept donations.[4]

Without statutory authority, SSB may not be able to accept donations to support its education efforts.

<u>Problem:</u> The lack of access to the State Securities Board undermines the agency's outreach efforts towards investors.

- The State Securities Board is a useful resource for investors who may contact the agency to request informative brochures on personal finance and fraud prevention, obtain information about the registration status of securities professionals or securities offerings, or file a complaint. However, SSB does not have a toll-free telephone number to provide investors throughout the State with easy access to information. In addition, despite SSB's positive steps toward collaborating with the National Fraud Complaint Management Center (NFCMC), the agency is not yet participating in this program.[5] Collaborating with NFCMC would enable SSB to receive dispatched calls made to the Center from Texas investors reporting fraud or requesting information.
- Additionally, although the agency's Web site contains useful information about the agency and investor education programs, it does not provide a specific e-mail address to request information. SSB's Web site does offer a "webmaster" email address through which some investors have reached the agency, but this address is not clearly marked for that purpose.

- By Board rules, securities professionals must clearly display their license to their clients to show proof of registration. However, SSB does not require that the agency's phone number be advertised on securities professionals' licenses. In parallel, the agency does not require that its name and phone number be advertised at the time investors contract with securities professionals. Consequently, many investors may not be aware which agency regulates the securities industry in Texas or what number to call to file a complaint or request information.

<u>Comparison:</u> **Several Texas and other states' regulatory agencies provide for consumer education and toll-free telephone numbers**.

- The Legislature has provided other Texas agencies, such as the Office of Consumer Credit Commissioner, the Department of Agriculture, and the Department of Housing and Community Affairs, with the authority to do consumer education as part of their overall regulatory efforts.

  Eleven other states' securities statutes provide for investor education, including nine that provide for the creation of a fund, established from fees and fines levied on the securities industry, contributing toward educating investors.

- Several Texas' agencies such as the Department of Agriculture, the Office of Consumer Credit Commissioner, and the Office of the Attorney General are statutorily authorized to accept donations.

- Fifteen other states securities regulatory authorities, and other Texas agencies, such as the Texas Department of Insurance, the Texas Department of Public Safety, and the Texas Workers' Compensation Commission, provide a toll-free telephone number for complaints or information.

  Other Texas agencies, such as the Office of Consumer Credit Commissioner, the Savings and Loan Department, and the Texas Department of Insurance require that the agencies' toll free numbers be advertised on written disclosure documents provided by regulated entities.

Many investors may not be aware of how, or with whom, to file a complaint about a securities problem in Texas.

Recommendation

Change in Statute

4.1 Specify in the Securities Act that investor education is a function of the State Securities Board.

This recommendation would require SSB to educate the public as part of the agency's statutory mission to protect investors. An investor education program should inform the public about the basics of investing and how to detect and avoid securities fraud. In the implementation of this program, SSB could collaborate with other organizations having an interest in investor education, such as the National Institute for Consumer Education (NICE) and the Texas Agricultural Extension Service.

4.2 Grant the State Securities Board statutory authority to accept gifts, grants, and donations for use in educating investors.

This recommendation would clarify SSB's authority to accept gifts, grants, and donations for use in the agency's education program. This change would extend SSB's appropriation rider authority to include the acceptance of donations for the entire education program — not just the distribution of teaching materials to high school teachers. In accordance with the Government Code, the agency could only accept a gift if the Board approves. The Code would also prevent the agency from accepting a donation from a party in a contested case until a month after a final decision is made. In addition, SSB could not accept gifts, grants or donations from a person who is affiliated with the securities industry.

Management Action

4.3 Require the State Securities Board to maintain a toll-free number and collaborate with the National Fraud Complaint Management Center to handle investors' questions and complaints.

This recommendation would require SSB to maintain a toll-free telephone number, restricted to Texas, to answer investors' questions and requests for documentation. To advertise its toll-free number, the agency would be required to print its name and number on securities professionals' licenses, and on a written document distributed by securities professionals when contracting with investors. This recommendation would also require the agency to collaborate with the National Fraud Complaint Management Center to receive complaints and inquiries made to the Center and addressed to SSB.

4.4 Require the State Securities Board to maintain an e-mail address on its Web site to specifically handle questions and requests for documentation from investors and securities professionals.

This recommendation would require SSB to create a new e-mail address on its Web site that would specifically handle questions and requests for documentation from investors and securities professionals.

Impact

An investor education program would allow the State Securities Board to more effectively achieve its statutory mission of protecting investors. The program would supplement SSB's efforts to prevent fraud and protect investors on the front end instead of trying to recover funds after fraud has occurred. The program should enable investors to make more educated investment decisions and empower them to protect themselves against fraud. The State Securities Board's toll-free number, e-mail address, and collaboration with the National Fraud Complaint Management Center would be an integral part of the agency's efforts to reach and educate investors. In addition, granting SSB statutory authority to accept donations would clarify that the agency can legally accept gifts and funds to supplement its education program.

Fiscal Implication

The State Securities Board has requested a special appropriation of $77,500 for FY 2002 to fund an investor education program. These funds would pay for the program's operating expenses and one full-time employee to manage the program. Establishing and maintaining a toll-free number restricted to Texas would have a minimal fiscal impact and could be absorbed by the agency's overall budget.

Fiscal Year	Cost to the General Revenue Fund	Change in FTEs in FY 2001
2002	$77,500	+1
2003	$77,500	+1
2004	$77,500	+1
2005	$77,500	+1
2006	$77,500	+1

[1] U.S. Congress, House Commerce Committee Subcommittee on Finances and Hazardous Materials, "Organized Crime on Wall Street," testimony by Bradley W. Sklolnik, Indiana Securities Commissioner and President of NASAA, September 13, 2000.

[2] Financial Literacy two thousand and one, "Financial Literacy 2001." Online. Available: http://www.fl2001.org/teach.pdf. Accessed: September 07, 2000.

[3] Ibid. Founded in 1997, Jump$tart is a non-profit organization whose goal is to ensure that students have skills to be financially competent upon graduation from high school. The coalition's partners include federal agencies, universities, associations, and sponsors of education programs.

[4] Government Code, §575.003 permits agencies to accept gifts if the agency's board approves *and* if the agency has authority to accept gifts. Whether the authority must be a statutory grant or whether the General Appropriations Act can grant this authority is unclear.

[5] The National Fraud Complaint Management Center (NFCMC) is an initiative of the National White Collar Crime Center which offers a support medium for law enforcement agencies to report incidents of fraud. NFCMC staff enter complaint information into a system database and forward it to the appropriate agency nationwide for further examination. The system detects if more than one agency could be involved, and notifies concerned parties.

National White Collar Crime Center, "National Fraud Complaint Management Center." Online. Available: http://www.nw3c.org/nfcmc.htm. Accessed: September 10, 2000.

Issue 5

Unlike Federal and Other States' Statutes, Texas Law Fails to Distinguish Between Securities Dealers and Investment Advisers.

Summary

Key Recommendation

- Define securities dealers, investment advisers, and their agents separately in the Securities Act.

Key Findings

- Securities dealers and investment advisers are two distinct professions regulated by the State Securities Board.
- The Securities Act's inclusion of investment advisers under the definition of "dealer" is confusing and does not account for the reality of business practices.
- Federal and other states' statutes separate the definitions of securities dealers, investment advisers, and their agents.

Conclusion

The State Securities Board regulates most securities dealers, investment advisers, and their agents, that do business in Texas. Although securities dealers and investment advisers are different professions, by including investment advisers under the definition of "dealer" the Securities Act does not appropriately recognize the separate nature of the professions. These recommendations would clarify the Securities Act and make it more consistent with the realities of business practices.

Support

<u>Current Situation:</u> Securities dealers and investment advisers are two distinct professions regulated by the State Securities Board.

- The State Securities Board (SSB) regulates most securities dealers, investment advisers, and their agents, that do business in Texas. The agency registers firms and individuals, and investigates and takes action against violations of the Securities Act.

  Other entities also regulate securities dealers and investment advisers. For example, the federal Securities and Exchange Commission (SEC) regulates investment advisers with more than $25 million in client assets under management, while SSB has exclusive jurisdiction over advisers who manage less than $25 million in assets. In addition, the National Association of Securities Dealers, SEC, and SSB coordinate inspections of securities dealers.

- Securities dealers and investment advisers are two related, but distinct, professions. Securities dealers earn commissions for securities transactions completed for a client. Investment advisers are paid for advice, recommendations, or analysis on securities. The table, *Differences Between Investment Advisers and Securities Dealers,* provides some key differences between the two professions. Agents may be employed by either a securities dealer or an investment adviser to sell securities or give advice on their behalf respectively. In 1999, SSB registered 3,101 securities dealers, 2,066 investment advisers, and 157,687 agents.

Differences Between Investment Advisers and Securities Dealers

Professions	Services Provided	Methods of Payment
Investment Adviser	• Provides financial advice, such as how to plan for future retirement or pay for children's college education • May provide continuous management by overlooking a client's portfolio and reallocating funds	• Flat hourly fee • Fee based on the assets under management • Performance-based fee (adviser shares in the client's profits once a benchmark of profitability is obtained) • A combination of all three methods
Securities Dealer	• Primarily acts as salesman and may provide some advice	• Paid for each transaction as a flat-fee, percentage of the transaction, or a combination

<u>Problem:</u> The Securities Act's inclusion of investment advisers within the definition of "dealer" is confusing and does not account for the reality of business practices.

- Although securities dealers and investment advisers perform different functions, the Securities Act includes investment advisers within the definition of dealers. The Act also include agents of securities dealers and investment advisers under one definition.

- By defining securities dealers and investment advisers in the same fashion, the Securities Act creates confusion and unintended consequences. This lack of clarity leaves open to interpretation which provisions apply to one profession or to both. For example, some securities professionals have argued that the Securities Act's cease and desist provisions do not apply to unregistered investment advisers and their agents because of the context in which the Act uses the word "dealer."[1]

Comparison: Federal and other states' statutes separate the definitions of securities dealers, investment advisers, and their agents.

- Federal law and the securities statutes of all other states define securities dealers and investment advisers separately.
- The SEC and the securities statutes of at least 44 states, other than Texas, distinguish between the agents of securities dealers and investment advisers.

Recommendation

Change in Statute

5.1 Define securities dealers, investment advisers, and their agents separately in the Securities Act.

This recommendation would distinguish between securities dealers and investment advisers, and between the agents of securities dealers and investment advisers. The definition of securities dealers would include only individuals and firms involved in the offer or sale of securities. The definition of investment adviser would include individuals or firms engaged in giving investment advice or analysis for compensation. This definition would exclude any person whose performance of such services is solely incidental to the practice of his or her profession. This definition would also exclude federal covered advisers and any other person designated by rule or order of the Securities Commissioner.

Impact

Distinguishing between securities dealers and investment advisers would lessen the extent to which the Securities Act is subject to interpretation by clearly identifying which provisions apply to securities dealers, investment advisers, or both.

Fiscal Implication

These recommendations would not have a fiscal impact on the State.

[1] Section 23 of the Securities Act uses the terms "dealer" and "agent" in conjunction with the phrase, "sell or offer for sale" of a security. This does not encompass the work generally performed by an investment adviser.

Issue 6

Texas Has a Continuing Need for the State Securities Board.

Summary

Key Recommendation

- Continue the State Securities Board for 12 years.

Key Findings

- The State Securities Board's mission is to protect Texas investors.
- Texas has a continuing interest in maintaining a safe securities market.
- The State Securities Board has been effective in accomplishing its goal of protecting investors.
- No other federal, state, local, or private entity exists that can perform the functions of the State Securities Board.
- All other states use a statewide agency to enforce securities laws.

Conclusion

The State Securities Board's mission, to protect Texas investors through the enforcement of the Securities Act, is important to Texans. While changes in the Securities Act could improve SSB's operations, the State has benefitted from the agency's enforcement programs and no other federal, state, local, or private agency has the means to provide these functions.

The Sunset review evaluated the continuing need for an independent agency to enforce the Securities Act. The review assessed whether the agency's functions could be successfully transferred to another agency and looked at how other states provide for this function. The review concluded that the State Securities Board should be continued as an independent agency for 12 years.

Support

<u>Current Situation:</u> The State Securities Board's mission is to protect Texas investors.

- The State Securities Board has an important role in maintaining Texas' financial markets by enforcing laws against securities fraud and keeping investors' confidence in the markets. The Legislature created SSB in 1957. SSB functions not to regulate risk, but to act against fraudulent dealers and enforce statutes requiring full disclosure of risks.

- The agency accomplishes its primary mission of investor protection through four core functions: analysis of securities offerings, evaluation of securities dealer and investment adviser applications, inspections of securities dealers and investment advisers, and law enforcement. The Securities Board's responsibility for registrations is shown in the table, *Registration Workload of the State Securities Board*.

The State Securities Board's role in policing Texas' $307 billion securities market helps to protect the state's economic health.

<u>Need for Agency Functions:</u> Texas has a continuing interest in maintaining a safe securities market.

- Maintaining safe securities markets encourages capital formation in Texas. Securities markets provide needed capital to entrepreneurs who wish to start or expand companies and provide a means for investors to achieve their financial goals. Without laws regulating the sale of securities, fraud and misrepresentation could run rampant.[1] When fraud remains unchecked, public confidence in investments erodes and securities markets dry up, thus affecting the state's economic health.[2]

- Texas has one of the largest securities markets in the U.S. The State Securities Board registered 26,800 offerings in 1999 that amounted to $307 billion in securities, even though securities that are traded on national markets, such as the New York Stock Exchange, are exempt from state registration. The agency also registered 3,100 securities dealers and 2,100 investment advisers that are subject to inspection by SSB. The primary purpose of SSB's securities registration program is to ensure that full disclosure of material investment information is made to investors in a consistent, standard manner. SSB also ensures that the promoter and investor share in the results of the venture, conflicts of interest are minimized, and promotional expenses are reasonable.

Registration Workload of the State Securities Board
Fiscal Year 1999

Registration	Number
Securities Offerings	26,811
Broker Dealers*	3,101
Investment Advisers Registered	2,066
Agents of Broker Dealers or Investment Advisers	157,687

* Dealers and Advisers that are subject to inspection.

<u>Agency Effectiveness:</u> The State Securities Board has been effective in accomplishing its goal of protecting investors.

- With the presence of SSB's enforcement and registration functions, Texas has a generally safe securities market. Through the actions of SSB, Texas, in recent years, has had the highest number of criminal convictions for securities fraud in the U.S.[3] The table, *SSB Enforcement Actions – 1999*, shows the number of administrative, civil, and criminal cases the agency brought in the most recent year for which statistics are available. Through these actions the agency collected $404,000 in administrative fines and secured $13.1 million in restitution to Texas investors.[4]

SSB Enforcement Actions - 1999

Action	Number
Administrative Orders	178
Civil Actions	71
Criminal Indictments	141
Criminal Convictions	85
Total	**475**

- Independent observers, such as federal regulators and national securities dealers associations, have praised the efforts of SSB in combating fraud, citing the Texas agency as one of the best state securities agencies in this regard.[5]

- In addition to enforcement actions, SSB has also tried to encourage the growth of securities markets in Texas. For example, the agency has organized an annual Venture Capital Conference which attracts investors to Texas and which, to date, has raised more than $100 million for small businesses in Texas.[6]

<u>Need for Agency Structure:</u> No other federal, state, local, or private entity exists that can perform the functions of the State Securities Board.

- The U.S. Securities and Exchange Commission performs a role very similar to SSB — it seeks to protect securities investors by enforcing laws against fraud. However, SSB's role is independent of that of the federal regulator because SEC only regulates securities that are sold in national markets, and does not oversee the activities of investment advisers with less than $25 million in assets under management. Without the efforts of SSB, the sale of some $307 billion in securities in Texas would be largely unregulated by any governmental body, and 2,100 unlicensed investment advisers would hold some $20 billion in investor funds.

SSB takes enforcement actions, helps collect restitution for defrauded investors, and encourages the growth of securities markets.

- No other state agency is prepared to take on SSB's function. For example, the Department of Public Safety investigates complex crimes, but has no ability or expertise in enforcing securities laws. To give DPS the expertise to take on SSB's functions would require a transfer of budgets and personnel without any real savings or benefit.

Local prosecutors have praised SSB for its assistance in bringing securities cases.

- Local District Attorney offices prosecute most of SSB's cases, but these DAs rely upon SSB's assistance (in many cases SSB officials sit in the second chair during prosecutions) and would not be able to fully perform this function. Local prosecutors praised the work of the agency to Sunset staff and commented that many securities cases would never be brought without the actions of the agency.[7]

- Securities dealers may also be registered with a private corporation, the National Association of Securities Dealers (NASD), which also owns the NASDAQ stock exchange and was created through an authorization in federal law. While NASD registers, inspects, and may take strong enforcement actions against its members, the State's role is still necessitated by the fact that NASD, as a private organization, may withdraw from Texas at any time and has no power to bring criminal sanctions against fraudulent activities. In addition, NASD does not oversee the activities of investment advisers.

<u>Comparison:</u> All other states use a statewide agency to enforce securities laws.

- All states have chosen to regulate the sale of securities on a statewide basis through a state agency. The major organizational structures used by states include housing the securities regulation function in the Secretary of State's Office, having securities regulation as a stand-alone agency as Texas has chosen to do, and consolidating the securities regulation function with banking or insurance regulation.[8] The table, *State Organization of Securities Function*, details the various governmental organizational schemes.

State Organization of Securities Function

Organizational Structures	States
Secretary of State Office or State Corporation Agency	16
Stand-Alone Securities Agency	13
Consolidated Financial Regulatory Agency (with Banking or Insurance)	12
Justice Department or Attorney General's Office	5
Economic Development Agency	3
State Auditor's Office	2

Recommendation

Change in Statute

6.1 Continue the State Securities Board for 12 Years.

Impact

This recommendation would continue the State Securities Board as an independent agency, responsible for overseeing Texas' securities market and protecting investors from fraudulent activities.

Fiscal Implication

If the Legislature continues the current functions of State Securities Board, using the existing organizational structure, the agency's annual appropriation of $3.5 million would continue to be required for its operation. If the Legislature does not continue SSB, and the Securities Act is allowed to expire, the State would lose $111 million in General Revenue from registration fees on securities, dealers, and investment advisers.

1 Caleb Patterson, Sam McAlister, George Hester, *State and Local Government in Texas*, 1945, New York, pg. 347.

2 Federal Bureau of Investigation Economic Crime Unit, "About the Economic Crimes Unit." Online. Available: http://www.fbi.gov/programs/fc/ec/about/about scf.htm. Accessed: September 9, 2000.

3 State Securities Board, *Supplement to the Annual Report*, August 1999, pg. 3.

4 State Securities Board, *Supplement to the Annual Report*, August 1999, pg. 3.

5 Interviews with Harold Degenhardt, District Administrator U.S. Securities and Exchange Commission (Dallas, Texas, July 13, 2000); Bernerd Young, Director NASD Regulation, Inc., District 6, (Dallas, Texas, July 14, 2000).

6 State Securities Board, *Strategic Plan for 2001-2005,* June 1, 2000, pg. 5.

7 Interview with Brian Flood, Dallas County Assistant District Attorney, (Dallas, Texas, July 14, 2000).

8 Information derived from the North American Securities Administrators Association, Inc., *2000 Directory*.

Across-the-Board Recommendations

State Securities Board	
Recommendations	**Across-the-Board Provisions**
	A. GENERAL
Already in Statute	1. Require at least one-third public membership on state agency policymaking bodies.
Apply	2. Require specific provisions relating to conflicts of interest.
Update	3. Require that appointment to the policymaking body be made without regard to the appointee's race, color, disability, sex, religion, age, or national origin.
Update	4. Provide for the Governor to designate the presiding officer of a state agency's policymaking body.
Update	5. Specify grounds for removal of a member of the policymaking body.
Apply	6. Require that information on standards of conduct be provided to members of policymaking bodies and agency employees.
Apply	7. Require training for members of policymaking bodies.
Apply	8. Require the agency's policymaking body to develop and implement policies that clearly separate the functions of the policymaking body and the agency staff.
Update	9. Provide for public testimony at meetings of the policymaking body.
Modify	10. Require information to be maintained on complaints.
Apply	11. Require development of an equal employment opportunity policy.
Apply	12. Require information and training on participation in the State Employee Incentive Program.

State Securities Board	
Recommendations	**Across-the-Board Provisions**
	B. LICENSING
Already in Statute	1. Require standard time frames for licensees who are delinquent in renewal of licenses.
Update	2. Provide for notice to a person taking an examination of the results of the examination within a reasonable time of the testing date.
Do Not Apply	3. Authorize agencies to establish a procedure for licensing applicants who hold a license issued by another state.
Do Not Apply	4. Authorize agencies to issue provisional licenses to license applicants who hold a current license in another state.
Already in Statute	5. Authorize the staggered renewal of licenses.
Already in Statute	6. Authorize agencies to use a full range of penalties.
Already in Statute	7. Revise restrictive rules or statutes to allow advertising and competitive bidding practices that are not deceptive or misleading.
Modify	8. Require the policymaking body to adopt a system of continuing education.

Agency Information

Agency Information

Agency at a Glance

The mission of the Texas State Securities Board (SSB) is to protect investors from securities fraud to assure that businesses in Texas have access to capital. The textbox, *What is a Security?*, defines securities. To achieve its mission, the agency registers securities offerings, licenses and inspects securities professionals, investigates fraudulent securities offerings, and enforces violations of the Securities Act. The State Securities Board cannot and does not attempt to regulate the risks inherent in securities dealings, but acts to ensure that all risks and other important facts relevant to a securities purchase are disclosed. The textbox, *Texas Securities Act,* lists some major provisions of the Act.

What is a Security?

According to the Securities Act, a security includes stocks; bonds and other debt instruments; interests in or under an oil, gas or mining lease; and investment contracts.

Texas Securities Act

- Prohibits the use of fraud in the offer or sale of securities.
- Requires that securities be registered or exempted before they are offered or sold.
- Requires that securities dealers, investment advisers, and their agents be registered.
- Provides for criminal, civil, and administrative penalties for violations of the Act's provisions.

Key Facts

- **Funding.** The State Securities Board's funding for fiscal year 1999 was about $3.5 million. While all of the agency's revenue comes from the General Revenue Fund, in fiscal year 1999, the agency collected about $107 million more in fees than it expended.
- **Staffing.** The State Securities Board employs 81 full-time employees – 67 working in the Austin headquarters, and 14 located in the Dallas, Houston, Corpus Christi, and Lubbock enforcement field offices.
- **Securities Law Enforcement.** Investigating and prosecuting violations of securities laws accounts for about one-third of the agency's budget. The agency focuses on obtaining indictments against individuals who violate the Securities Act. Agency staff assist prosecutors by forwarding them complete investigations and participating in all phases of trials.
- **Securities Dealers Registration.** The agency requires securities dealers, investment advisers, and their agents, to register to ensure that they meet minimum standards of conduct and financial solvency.
- **Dealer Inspections.** The agency inspects securities dealers and investment advisers to ensure compliance with the Securities Act and Board rules.

- **Registration of Securities Offerings.** The agency reviews all applications to register securities for sale in Texas to ensure investor access to full and fair disclosure of all material investment information. The agency also helps ensure that both the promoter and investor share in the results of the venture, that conflicts of interest are minimized, and that promotional expenses are reasonable.

Major Events in Agency History

1957 The Legislature passed the Securities Act, creating the State Securities Board to register securities as well as firms and individuals selling securities or providing investment advice, and to prosecute violations of the Act.

1963 The Legislature required individuals to pass a written examination before being registered to sell securities.

1996 Congress passed the National Securities Markets Improvement Act, which eliminated duplicative registration of mutual funds and split regulatory authority over investment advisers between the states and the federal government according to asset size.

Organization

Policy Body

The State Securities Board is governed by three part-time public members appointed by the Governor, with the advice and consent of the Senate, for six-year staggered terms. The table, *SSB's Governing Board*, lists the current members. The Board meets every three to four months to set policy for the agency through the Board's rulemaking authority. The Board also appoints a Commissioner who serves at the pleasure of the Board to administer the Securities Act. The Board may exercise any power or perform any act authorized for the Securities Commissioner.

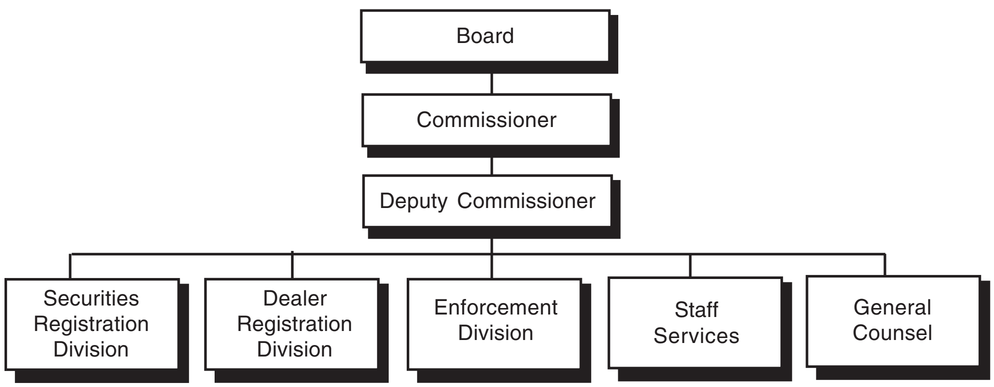
SSB's Governing Board

Nicholas C. Taylor, Chair ***Midland***	Appointed 4/6/95 Term Expires 1/20/01
Jose Adan Trevino ***Bellaire***	Appointed 3/12/97 Term Expires 1/20/03
Kenneth W. Anderson, Jr. ***Dallas***	Appointed 5/7/99 Term Expires 1/20/05

Staff

The Securities Commissioner serves as the chief administrative officer of the agency and is responsible for supervising its day-to-day activities. SSB is organized into five divisions: Securities Registration, Dealer Registration, Enforcement, General Counsel, and Staff Services. Each employee is covered by an honesty blanket position bond. The chart, *State Securities Board Organizational Chart*, illustrates the organizational structure of the agency.

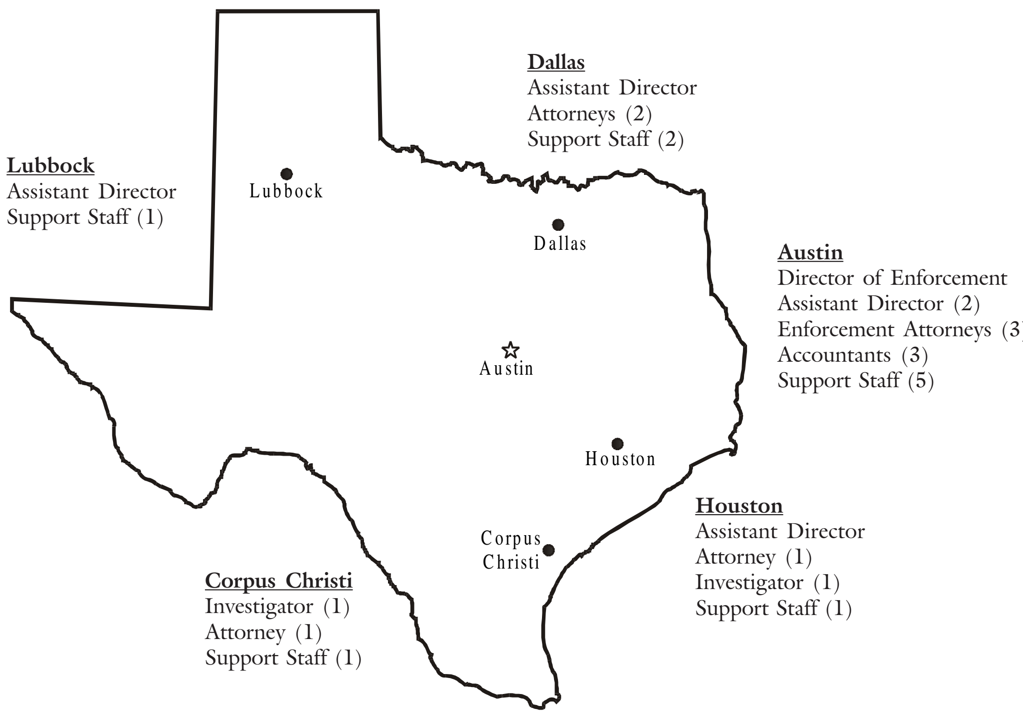
State Securities Board
Organizational Chart



In FY 1999, SSB had a staff of 81 employees, with 67 located at the agency's headquarters in Austin. The remaining 14 employees were distributed among the agency's four enforcement field offices in Corpus Christi, Dallas, Houston, and Lubbock. The map, *SSB Field Offices and Staff*, delineates the agency's field structure and number of employees per location. Appendix A, *Equal Employment Opportunity Statistics, 1996 to 1999*, compares the agency's workforce composition to the minority civilian labor force.

The agency staff perform a wide variety of complex tasks to ensure that investors are adequately protected. In FY 1999, the agency processed 26,811 securities applications and filings, registered 162,854 individuals and businesses to sell securities or render investment advice in Texas, initiated 528 enforcement actions, and conducted 164 inspections.

State Securities Board Field Offices and Staff



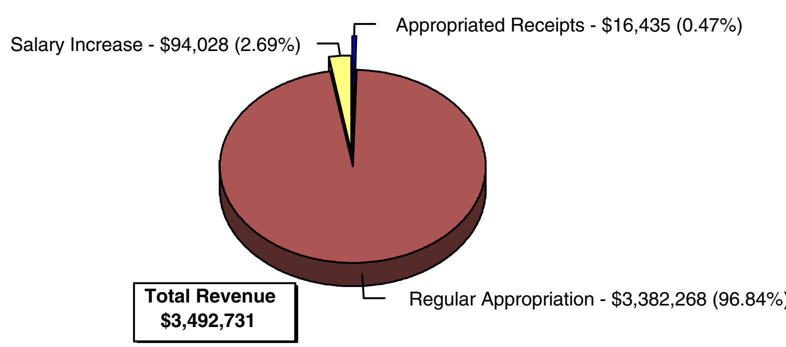
Funding

Revenues

In fiscal year 1999, SSB received about $3.5 million in funding from General Revenue. That year, the agency collected about $107 million more in fees than it expended. The chart, *Sources of Revenue - Fiscal Year 1999,* provides funding details.

In fiscal year 1999, SSB collected about $107 million more in fees than it expended.

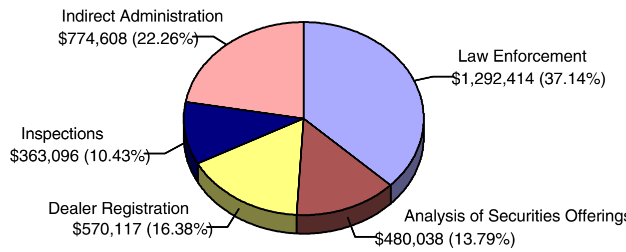
Sources of Revenue
Fiscal Year 1999



Expenditures

In fiscal year 1999, SSB's $3.5 million expenditures were distributed among the agency's four programs and its indirect administration and support. The Law Enforcement program received the most funding, followed by the Dealer Registration program. The chart, *Expenditures by Strategy - Fiscal Year 1999,* details SSB's expenditures. Appendix B, *Historically Underutilized Businesses Statistics, 1996 to 1999,* describes SSB's use of Historically Underutilized Businesses (HUBs) in purchasing goods and services.

Expeditures by Strategy
Fiscal Year 1999



Total Expenditures
$3,480,273

Agency Operations

The agency accomplishes its primary mission of investor protection through four core functions: analysis of securities offerings; evaluation of dealer, adviser and agent applications; inspections; and law enforcement. The table, *Registration Workload of the State Securities Board,* provides a picture of the industry the agency regulates.

Registration Workload of the State Securities Board

Registration	Number
Securities Offerings	17,375
Securities Dealers	3,101
Investment Advisers	2,066
Agents	157,687

Analysis of Securities Offerings

The agency requires the registration of securities offerings in Texas to provide investors with full disclosure of all material information. Certain national securities offerings and other transactions are exempt from the registration requirements of the Act. Staff refers fraudulent securities offerings to the agency's law enforcement program.

The passage of the National Securities Markets Improvement Act (NSMIA) significantly decreased the number of applications requiring registration review. Many of the applications are now notice filings, which require no additional analysis. In 1996, 17 employees processed 18,887 applications annually. In 1999, after passage of NSMIA, nine employees were able to process 26,811 applications. The textbox, *National Securities Markets Improvement Act,* provides additional information about the impact of NSMIA.

National Securities Markets Improvement Act (1996)

- Eliminates duplicative registration for certain national securities offerings among state and federal agencies.
- Divides regulatory responsibility and oversight of investment advisers between the states and the U.S. Securities and Exchange Commission.
- Does not affect certain direct participation programs and small corporate securities offerings.
- Eliminates state responsibility for registration review of mutual fund offerings.

Evaluation of Dealer, Adviser, and Agent Applications

The State Securities Board ensures that securities dealers operating in Texas meet a minimum standard of qualifications, conduct, and financial solvency. SSB reviews applications from firms and individuals seeking to operate as dealers, investment advisers, or agents. The agency evaluates applicants based on the following four criteria:

- performance on written examinations;
- evidence of past fraudulent business practices;
- prior conviction of a crime; and
- financial solvency.

In fiscal year 1999, the agency approved 41,200 new registrations, renewed 121,645, and canceled 30,312 registrations.

Inspections

The State Securities Board inspects registered securities dealers and investment advisers for compliance with the Securities Act and Board rules. Inspectors assess whether sales practices are correctly executed and attempt to address problems before investors are harmed. On average, SSB inspects investment advisers every eight years. The agency conducts inspections of securities dealers independently or jointly with the Securities and Exchange Commission and the National Association of Securities Dealers (NASD). Inspectors notify securities professionals to take corrective action against minor deficiencies noted during an inspection, and refer serious violations to agency law enforcement staff. In fiscal year 1999, SSB conducted 164 inspections resulting in the detection of 45 individuals or firms not complying with the Securities Act or the Board rules, and the referral of seven cases to enforcement.

Recent federal legislation has placed significantly more responsibility on SSB's inspection program.

The passage of NSMIA has placed significantly more responsibility on the inspection program. Staff must ensure that investment advisers with less than $25 million of client assets under management, solely subject to SSB's regulatory oversight, comply with the Securities Act. These investment advisers effectively control as much as $20 billion in investor funds.

Law Enforcement

The agency enforces the Securities Act through the use of criminal, civil, and administrative penalties. The agency emphasizes criminal indictments for individuals selling fraudulent securities. In fiscal year 1999, SSB initiated 528 enforcement actions. As its largest program, the State Securities Board employed 27 full-time employees and expended more than $1.2 million to enforce securities laws in Texas.

The State Securities Board's detection of securities violations is based on intelligence gathering. The agency routinely monitors securities advertisements on the Internet and in newspapers, and investigates consumer complaints and referrals from other agencies or law enforcement officials. To investigate potential fraud, agency staff go undercover into the place of business where fraud is allegedly occurring, interview investors, take testimonies, and subpoena documents.

SSB's detection of violations is based on intelligence gathering.

Once SSB confirms fraud or securities violations, the agency works with the U.S. Attorney's Office and local district attorney's offices to convict criminal violators, forwards completed investigations to district attorneys for civil action, and tries administrative cases before the State Office of Administrative Hearings. To assist in the prosecutions of criminal and civil cases, agency attorneys participate in the drafting of pleadings and orders, and may represent the State during trials. To obtain administrative sanctions, enforcement attorneys argue before an administrative law judge for the necessity of the proposed sanctions.

APPENDICES

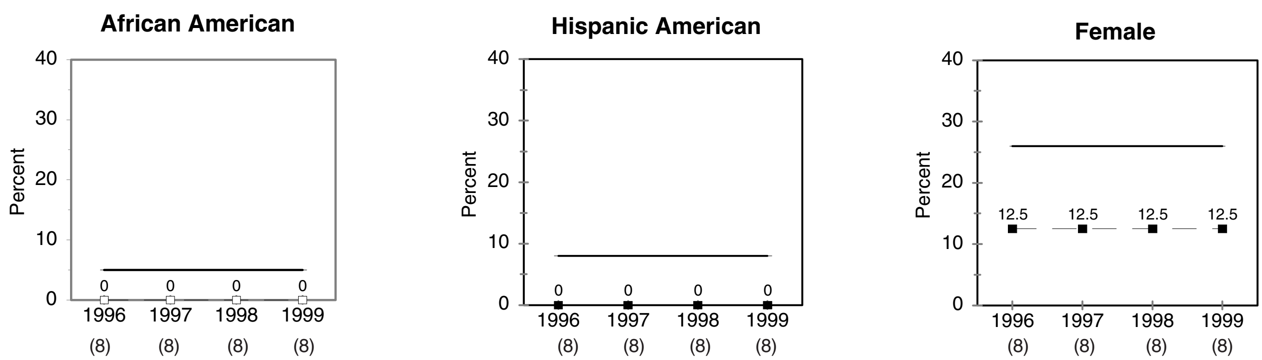
Appendix A

Equal Employment Opportunity Statistics

1996 to 1999

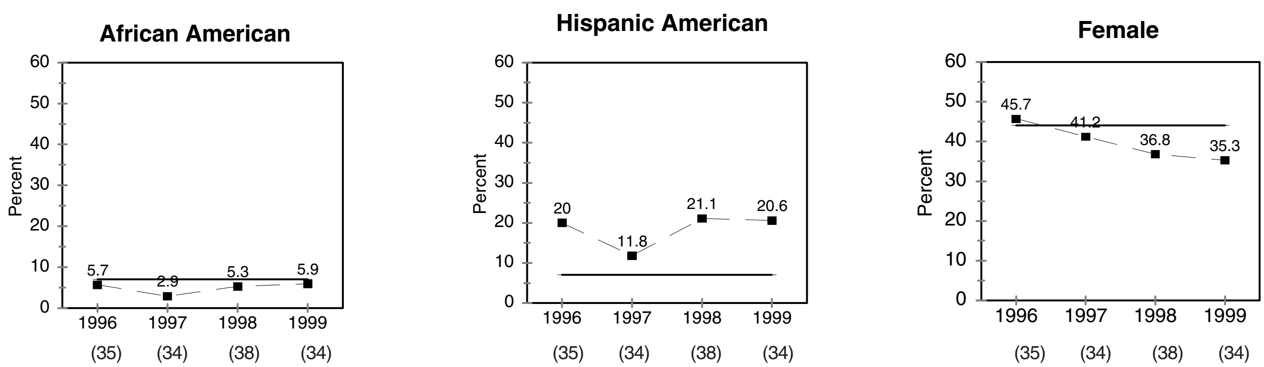
EEO Information
A comparison of the agency's workforce composition to the minority civilian labor force is shown in the chart, ***State Securities Board - Equal Employment Opportunity Statistics.*** The agency has generally met or exceeded Civilian Labor Force levels for most job categories.

State Agency Administration



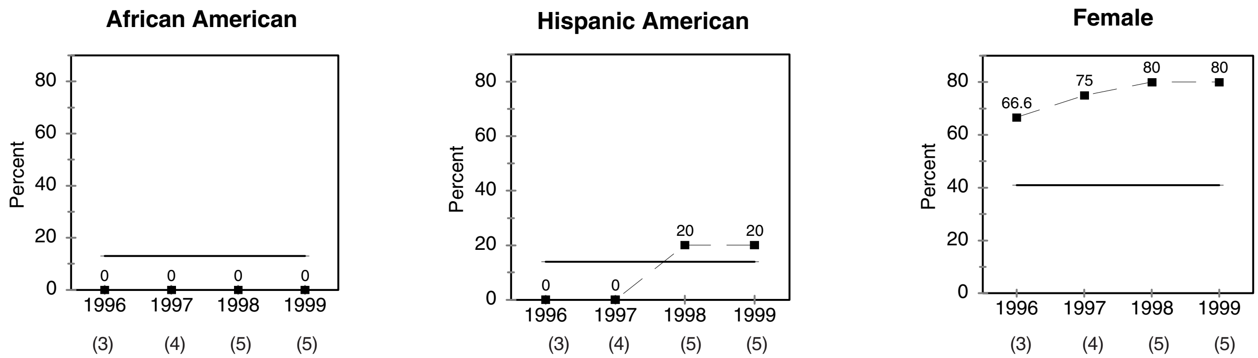
The agency consistently lagged behind civilian labor force percentages for each categories.

Professional



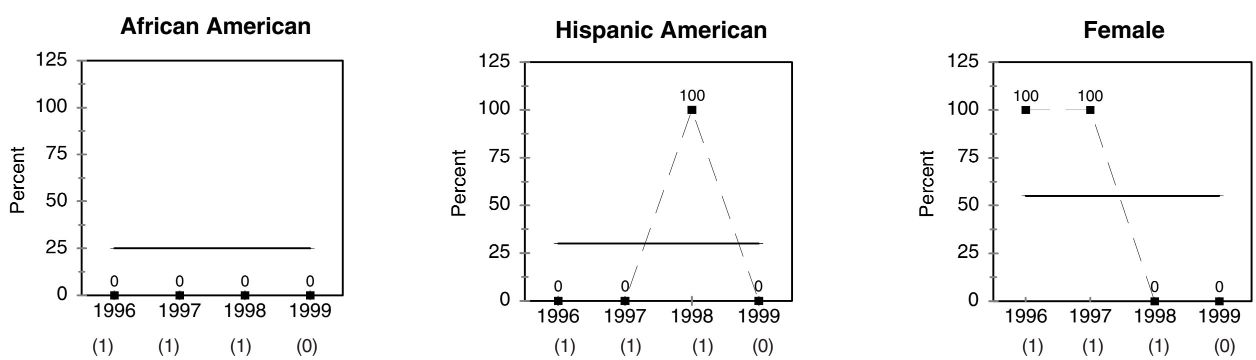
The agency fell short of meeting civilian labor force percentages for African Americans, and Females (with the exception of 1996), but exceeded state goals for Hispanic Americans.

Technical



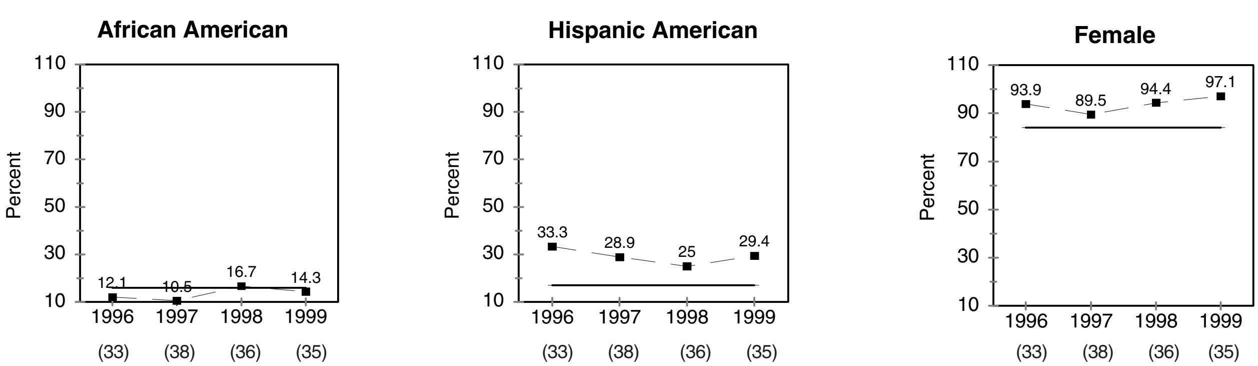
The agency fell below civilian labor force percentages for African Americans, but exceeded state goals for Females, and Hispanic Americans since 1998.

Paraprofessional



The agency employed only one Paraprofessional in 1996, 1997, and 1998. SSB no longer provides job opportunities in this category.

Administrative Support



With the exception of African Americans, the agency exceeded minority civilian labor force percentages.

Protective Services

The agency does not provide job opportunities in the Protective Services category.

Skilled Craft

The agency does not provide job opportunities in the Skilled Craft category.

Service Maintenance

The agency does not provide job opportunities in the Service Maintenance category.

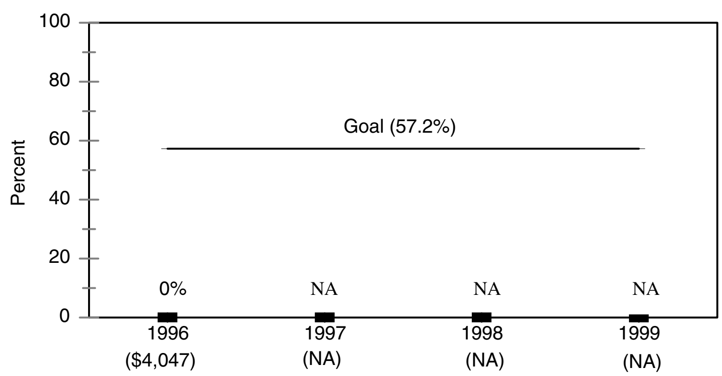
Appendix B

Historically Underutilized Businesses Statistics

1996 to 1999

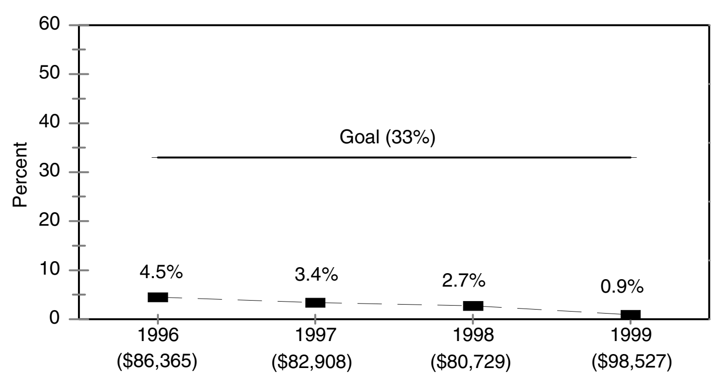
The Legislature has encouraged state agencies to use Historically Underutilized Businesses (HUBs) to promote full and equal opportunities for all businesses in state procurement. In accordance with the requirements of the Sunset Act, the following material shows trend information for the agency's use of HUBs in purchasing goods and services.[1] The agency maintains and reports this information under guidelines in the General Services Commission's enabling statute.[2] In the charts, the flat lines represent the goal for each purchasing category, as established by the General Services Commission. The dashed lines represent the agency's actual spending percentages in each purchasing category from 1996 to 1999. Finally, the number in parentheses under each year shows the total amount the agency spent in each purchasing category.

Special Trade



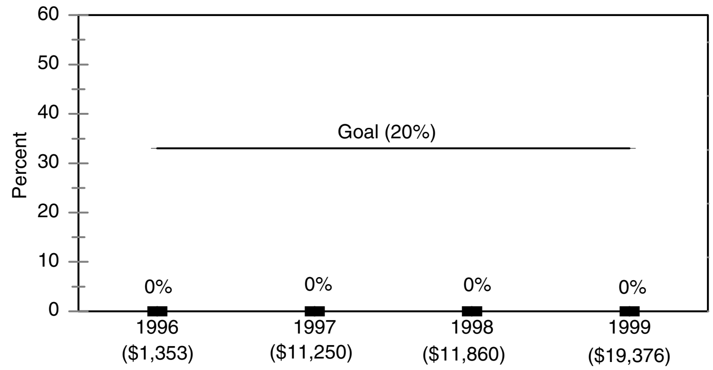
The agency did not purchase goods in special trades in 1997 through 1999.

Other Services



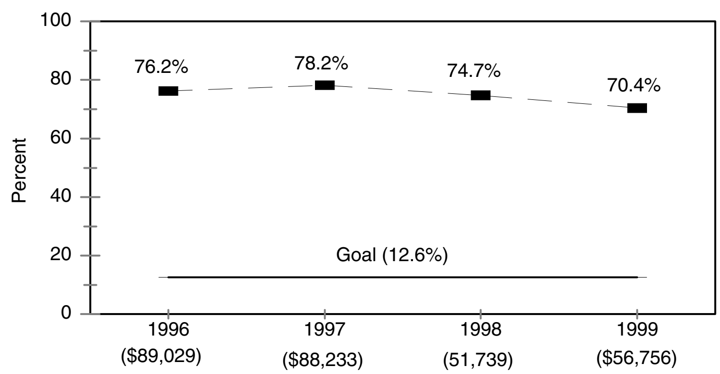
The agency consistently fell below HUB purchasing goals for other services.

Professional Services



The agency did not purchase professional services from HUB sources in the past four years.

Commodities



The agency significantly exceeded HUB purchasing goals for commodities.

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[1] Tex. Gov't. Code ch. 325, sec. 325.011(9)(B) (Vernon 1999).

[2] Tex. Gov't. Code ch. 2161, (Vernon 1999). Some provisions were formerly required by rider in the General Appropriations Act.

Appendix C

Staff Review Activities

The Sunset staff engaged in the following activities during the review of State Securities Board.

- Worked extensively with SSB staff at the Austin headquarters and in the Houston and Dallas enforcement fields.
- Met with SSB Commission members and attended a public meeting of the Securities Commission.
- Participated in SSB's inspection of an investment adviser.
- Met with the Texas Department of Insurance and the Office of Consumer Credit Commissioner, and held telephone interviews with the National Institute for Consumer Education, the Financial Education 2001 program, and the Texas Agricultural Extension Service, to review personal finance education programs.
- Attended a workshop hosted by OCCC to educate Texas Department of Aging employees about home equity lending as part of OCCC's education program.
- Held a telephone interview with the National Fraud Complaint Management Center to inquire about its national hotline.
- Solicited written comments and held interviews with national and state interest groups, including the Securities Industry Association, the Investment Company Institute, the Investment Counsel Association of America, the National Association of Securities Dealers, the Texas Stock and Bond Dealers Association, the North American Securities Administrators Association, and Consumer Union.
- Visited the District Attorney's Office, the National Association of Securities Dealers, and the federal Securities and Exchange Commission in Dallas.
- Met with the Legislative Budget Board, reviewed the State Auditor's Office and General Accounting Office's reports, and attended SSB's budget hearing.
- Researched and held telephone interviews with other states and the federal government regarding the structure, programs and statutory authority of agencies with common functions.
- Reviewed agency documents and rules; Texas and other states' statutes; interest groups, other states' and federal information; and Attorney General opinions.
- Performed background and comparative research using the Internet.

Sunset Review of the State Securities Board

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