
North American Securities Administrators Association

Standing Strong for Investors



**NASAA's Pro-Investor
Legislative Agenda
for the 112th Congress**

February 2, 2011 | Washington, DC

NASAA's Pro-Investor Legislative Agenda for the 112th Congress

Summary of Five Core Principles

Core Principle One: Support Strong Implementation of the Dodd-Frank Act

- At a minimum, we support funding the SEC at the \$1.3 billion level authorized by Dodd-Frank to carry out the functions, powers and duties of the Commission for FY 2011.
- State securities regulators strongly supported inclusion of the Senior Investor Protection Program and will work to see that the \$8 million annual authorization for these grants is funded by Congress.
- The Dodd-Frank Act made state regulators a more equal partner in the task of securities regulation by shifting mid-sized investment advisers from federal to state oversight. We object to any measures that would have the effect of weakening the states' important role in protecting our investors.

Core Principle Two: Reserve Regulation for Regulators

- NASAA urges Congress to reject proposals to establish additional SROs and to provide federal and state regulators with the resources they need to effectively monitor the firms and representatives under their jurisdiction. Another mechanism to fund the SEC's examination of investment advisers is through the use of user fees, as recommended by the SEC's staff in its recent Section 914 report to Congress.

Core Principle Three: Strengthen State/Federal Collaboration

- Additionally, given FINRA's present attempt to regulate investment advisers, now is a key time for state and federal regulators to enhance the state/federal regulatory structure to demonstrate a unified ability to regulate all aspects of the securities industry.
- An enhanced state/federal regulatory structure should include joint trainings, examinations, enforcement actions, prosecutions and investor education programs. There should be more regional meetings, monthly regional enforcement conference calls, possibly a joint investor complaint center, as well as more sharing of information and resources.
- State securities regulators appreciate congressional action to include in Dodd-Frank a provision to strengthen investor protection from securities law violators by including the disqualifier language to prevent recidivist violators of the law from conducting securities offerings under SEC Regulation D, Rule 506. However, in light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by repealing Subsection 18(b)(4)(D) of the Securities Act of 1933.

Core Principle Four: Impose a Fiduciary Duty on all Financial Professionals When Providing Investment Advice about Securities

- The Sec. 913 staff study is complete and the report has been submitted to Congress. NASAA recommends that the SEC use its authority under Section 913(f) of the Act to establish rules to address the standards of care for broker-dealers and investment advisers.
- The SEC now has unprecedented rulemaking authority to extend the fiduciary standard of conduct to broker-dealers who provide personalized investment advice about securities to retail customers, requiring them to act as fiduciaries and as such, to put investors' best interests before their own.
- Applying the fiduciary standard to broker-dealers is necessary to protect investors from abuses fostered by current fragmented industry standards. The time has come to end this confusion and close the longstanding gaps in industry standards. The SEC must act without delay.

Core Principle Five: Provide Transparency, Enhance Protections and Reserve Choice of Forum for Investors

- Pursuant to Section 921 of Dodd-Frank, Congress should urge the SEC to revisit the issue, prohibit the mandatory nature of pre-dispute securities arbitration, and allow investors the choice they ought to have between arbitration and litigation in an independent judicial forum.
- NASAA recommends that Congress enact legislation, proposed by the PCAOB, which would amend the Sarbanes-Oxley Act so that the PCAOB disciplinary proceedings will be open to the public, unless the Board orders otherwise in a particular case.
- NASAA supports the Senior Investor Protections Enhancement Act, which places higher penalties on those who target seniors with abusive sales tactics. The legislation, introduced by Senators Herb Kohl and Bob Casey in the last Congress, would impose additional penalties when violations are directed against seniors (62 or older), including administrative penalties of up to \$50,000 and civil penalties up to \$50,000 for each violation. We will work with Senators Casey and Kohl as this proposal moves through the legislative process.
- Section 929Z of the Dodd-Frank Act provides for a GAO study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. NASAA urges Congress to carefully consider the findings of this study. The pendulum has swung too far in the direction of limiting private rights of action for securities fraud, rather than protecting investors who have suffered losses. NASAA urges Congress to respect the principle that every wrong should have a remedy, and restore an effective private right of action under federal securities laws.

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It's been 100 years since the first blue sky law, which regulates the offering and sale of securities and protects the public from fraud, was enacted in Kansas in 1911. Since 1919, the members of North American Securities Administrators Association (NASAA) have been on the front lines of investor protection through their enforcement, licensing, registration, examination, and investor education activities. While the recent financial crisis was the result of many failures, we are proud to say that a failure of state securities regulation was not one of them.

The focus of NASAA's 2011 legislative agenda is to ensure that the investor protections included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) are not thwarted through a lack of funding, weakening of key provisions or delayed execution. Let us not forget that the Dodd-Frank Act was a law born out of necessity. Events in the markets made evident that the existing securities regulatory landscape required overhaul. One such recognition by Congress was that state regulators, with their "boots on the ground," were uniquely situated to address issues of concern nearest to them and most nimble in their responses. Time and time again, states have demonstrated not only their value to the regulatory landscape, but their primacy in it.

The Dodd-Frank Act ushered in a new era of heightened investor protection and strong financial market oversight to help prevent another economic crisis from occurring. State securities regulators are eager to help accomplish this important mission on behalf of Main Street investors throughout this country.

Our work is far from complete. NASAA will continue to work cooperatively with Congress and regulators to ensure that the studies, rulemakings and implementation procedures of the Dodd-Frank Act actually protect investors and strengthen investor confidence.

Core Principle One: Support Strong Implementation of the Dodd-Frank Act

The Dodd-Frank Act contains important measures to stabilize the American economy and protect investors. Clearly, the new law provides a number of long-awaited and much-needed protections for investors. In many respects, however, the legislation shifts the ultimate responsibility from Congress to federal agencies, which have been authorized or directed to conduct dozens of rulemakings that will decide whether, and in what form, safeguards important to investors will be delivered. For example, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) were given broad new and sorely needed regulatory authority over certain segments of our marketplace, such as over-the-counter derivatives and private funds. In spite of their increased responsibility, the agencies are operating at inadequate FY 2010 funding levels. The SEC has already deferred action on a number of new activities, such as the creation of the Office of Investor Advocate and the Investor Advisory Commission.

These important investor activities should not be delayed a moment longer because Congress has not provided sufficient funding for the federal financial regulatory agencies. At a minimum, we support funding the SEC at the \$1.3 billion level authorized by Dodd-Frank to carry out the functions, powers and duties of the Commission for FY 2011.

NASAA urges Congress not to undermine the new Dodd-Frank regulatory authority, either directly through legislative repeals or indirectly through a lack of appropriate funding.

Another provision in desperate need of funding is the Senior Investor Protection grant program to be established by the Office of Financial Education at the Consumer Financial Protection Bureau. The purpose of this program is to provide grants to states to fund additional resources, education materials and staff dedicated to cracking down on meaningless titles used by unscrupulous investment professionals to mislead investors about their expertise in senior financial issues. State securities regulators strongly supported its passage and will work to see that the \$8 million annual authorization for these grants is funded by Congress.

NASAA urges Congress not to undermine the new Dodd-Frank regulatory authority, either directly through legislative repeals or indirectly through a lack of appropriate funding. We call upon Congress to provide appropriate oversight to ensure that the Act is implemented with strong rulemaking that reflects the interests of Main Street investors, and to appoint qualified individuals who will carry out the intent and spirit of the law.

The Dodd-Frank Act made state regulators a more equal partner in the task of securities regulation by shifting mid-sized investment advisers from federal to state oversight. As a result, we estimate that approximately 4,000 investment advisers will switch from SEC to state registration, leaving the SEC to focus on the larger more systemically significant advisers. We welcomed this change and are working diligently to ensure a seamless, comprehensive and effective switching process. We object to any measures that would have the effect of weakening the states' important role in protecting our investors.

Core Principle Two: Reserve Regulation for Regulators

The Dodd-Frank legislative history specifically solidified state regulators' role in protecting investors, including a seat on the Financial Stability Oversight Council, increased state regulatory authority over investment advisers having assets under management from \$25 to \$100 million, and allowing investigation of misdeeds among filers of exempt Regulation D, Rule 506 securities, and more.

Continued oversight of investment advisers is a topic of considerable debate, and there are various proposals on how the oversight of investment advisers should be handled. One proposal is the formation of a self-regulatory organization (SRO) for investment advisers. NASAA firmly believes that when it comes to the important subject of investment adviser regulation, there is no regime superior to the governmental collaboration between the states and the SEC.

Investment adviser regulation is a governmental function that should not be outsourced to a private, third-party organization that does not have expertise or experience with investment adviser regulation. The designation of an SRO for the oversight of investment advisers, with its attendant direct and indirect costs, its opaque structure and attendant lack of accountability and transparency, would outweigh any perceived benefits to the investing public.

The chief concerns state securities regulators have with the designation of an SRO for the oversight of investment advisers are the collaboration, transparency, accountability and conflict issues that have always been inherent to the SRO model. While industry SROs had historically worked as a partner with the SEC and the states (creating what was referred to as the “three-legged stool” of regulation), this model recently changed based on an over-broad construction of the “government actor doctrine.” To avoid a classification as a “government actor,” the relevant SRO has restricted the release of information to the government and has affirmatively taken the position that it is prohibited from active collaboration with governmental regulators, including the governmental entity responsible for its oversight. As such, previous synergies with the SRO have been lost, and it has become increasingly difficult for the governmental regulators to meaningfully control oversight or investigations over registrants subject to the current SRO model.

Collaboration issues aside, the regulatory work performed by SROs lacks transparency. Although SROs have been performing governmental functions for decades, they are not subject to similar Freedom of Information Act (FOIA) and public records requirements as are the SEC and state securities regulators. Even where there is public disclosure by SROs regarding members, as in the case of BrokerCheck, the SRO has placed limitations and filters on regulatory records that far exceed FOIA provisions. The end result is that vital information is withheld from the investing public. Without greater transparency, investors cannot obtain the information they need to make informed decisions.

Finally, the current SRO model raises accountability and conflict concerns. Even where there is an independent Board of Directors, SROs remain organizations built on the premise of self-rule and are, as a matter of first principle, accountable to their members rather than the investing public. Ultimately, no matter how many safeguards are instituted, an SRO has substantial conflicts of interest that governmental regulators do not. This is particularly true in situations

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where industry and investor interests conflict, as in the case of mandatory pre-dispute arbitration clauses and the disclosure or expungement of historical settlements, judgments and investor claims. Ultimately, SROs simply cannot match the accountability of government regulators, nor the proximity and familiarity of state regulators, in particular, when considering investor protection and regulatory thoroughness.

As mentioned earlier, the total number of investment adviser registrants subject to SEC oversight will soon be reduced by approximately 4,000 firms (approximately a 36 percent decrease). Congress should support the SEC’s request for the examination and enforcement resources it

needs to frequently and comprehensively examine the activities of investment advisers subject to its oversight.

State and federal securities regulators have shown to be adept at responding to various resources, relying on its expertise to appropriately allocate them. With IAs, for example, government regulators have the experience to address changes or abnormalities in the firm community faster than would a new entrant to the space. In this time of precarious financial footing, investors need established regulation. Markets, products, practices and schemes move so quickly that on-the-job training simply will not do.

NASAA urges Congress to reject proposals to establish additional SROs and to provide federal and state regulators with the resources they need to effectively monitor the firms and representatives under their jurisdiction. Another mechanism to fund the SEC's examination of investment advisers is through the use of user fees, as recommended by the SEC's staff in its recent Sec. 914 report to Congress.

Core Principle Three: Strengthen State/Federal Collaboration

Support an enhanced state/federal regulatory structure to build confidence in our capital markets.

With respect to policy development, the Securities Act of 1933 stresses a federal policy that emphasizes "maximum uniformity in Federal and State regulatory standards." In recent years, cooperation has been an ongoing theme of both federal and state securities policy development and efforts by the states to harmonize state policies. Nevertheless, the degree of federal-state cooperation in securities regulation should not be overstated. Although there have been isolated policy differences between the SEC and NASAA, in general, the complementary system of state and federal securities regulation has worked well.

As the SEC's and states' budgets and resources have fluctuated in the past, the fraud waves that have occurred might have been mitigated to some degree had there been an enhanced state/federal regulatory structure and/or more state and federal regulatory cooperation. The expertise, resources and accessibility of state regulators, coupled with the expertise and resources of the SEC, could create a synergistic effect in the regulatory arena and could build more investor confidence in our capital markets. Both the SEC and the states perceive advantages to having more, rather than fewer, regulators involved, particularly to review filings, conduct examinations and bring enforcement actions.

Additionally, given FINRA's present attempt to regulate investment advisers, now is a key time for state and federal regulators to enhance the state/federal regulatory structure to demonstrate a unified ability to regulate all aspects of the securities industry.

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An enhanced state/federal regulatory structure should include joint trainings, examinations, enforcement actions, prosecutions and investor education programs. There should be more regional meetings, monthly regional enforcement conference calls, possibly a joint investor complaint center, as well as more sharing of information and resources.

Restore the authority of state securities regulators in certain areas.

Corporation and business law is principally state-derived law. State regulators, unlike federal regulators, are generally more accessible to the people in their communities and, in many instances, better able to identify and respond to investor protection issues. Federal law should not preempt or undermine state authority over securities firms, representatives, as well as the products they are selling.

One area to seek possible restoration of authority:

Regulation D, Rule 506 offerings. In 2009, 26,485 Regulation D, Rule 506 offerings were filed with the SEC with an estimated offering total of \$609 billion. That compares to 11,000 such offerings in 1996. As a result of the National Securities Markets Improvement Act of 1996, these private placements were largely "off the radar screen" since states are preempted from reviewing offerings under Rule 506 before they are marketed to investors and the SEC generally does not review them. These offerings also enjoy an exemption from registration under federal securities law, so they receive virtually no regulatory scrutiny. Some courts have even held that offerings made under the guise of Rule 506 are immune from scrutiny under state law, regardless of whether

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they actually comply with the requirements of the rule. As a result, Rule 506 offerings have become the favorite vehicle under Regulation D, and many of them are fraudulent.

Although Congress preserved the states' authority to take enforcement actions for fraud in the offer and sale of all "covered" securities, including Rule 506 offerings, this power is no substitute for a state's ability to scrutinize offerings for signs of potential abuse and to ensure that disclosure is adequate before harm is done to investors.

State securities regulators appreciate congressional action to include in Dodd-Frank a provision to strengthen investor protection from securities law violators by including the disqualifier language to prevent recidivist violators of the law from conducting securities offerings under SEC Regulation D, Rule 506.

However, in light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by repealing Subsection 18(b)4(D) of the Securities Act of 1933.

Core Principle Four: Impose a Fiduciary Duty on all Financial Professionals When Providing Investment Advice about Securities

NASAA urges prompt application of the fiduciary duty to all financial professionals who give personalized investment advice regarding securities – broker-dealers and investment advisers alike. This step will enhance investor protection, eliminate confusion and even promote regulatory fairness by establishing conduct standards according to the nature of the services provided, not the licensing status of the provider. For all financial professionals, the interests of the client must come first at all times. Investors deserve no less.

Over the last two decades, broker-dealers have increasingly engaged in services traditionally rendered by investment advisers. The conduct of investment advisers, broker-dealer agents and financial planners has become increasingly blurred in recent years, and most investors do not understand the legal obligations that each group owes to its clients.

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Section 913 of the Dodd-Frank Act directed the SEC to conduct a six-month study to evaluate the effectiveness of the existing standards of care for broker-dealers and investment advisers when providing personalized investment advice to retail customers. In addition, the study evaluated existing legal or regulatory gaps or overlaps with respect to such standards of care that should be addressed by rule or statute.

The staff study is complete and the report has been submitted to Congress. NASAA recommends that the SEC use its authority under Section 913(f) of the Act to establish rules to address the standards of care for broker-dealers and investment advisers. The SEC now has unprecedented rulemaking authority to extend the fiduciary standard of conduct to broker-dealers who provide personalized investment advice about securities to retail customers, requiring them to act as fiduciaries and as such, to put investors' best interests before their own. Applying the fiduciary standard to broker-dealers is necessary to protect investors from abuses fostered by current fragmented industry standards. The time has come to end this confusion and close the longstanding gaps in industry standards. The SEC must act without delay.

A uniform duty standard of conduct for any professionals who provide investment advice to retail customers is necessary to harmonize the existing legal and regulatory standards of care for brokers, dealers, investment advisers and persons associated with them when providing personalized investment advice and recommendations about securities to retail investors. When receiving investment advice, investors deserve and should be afforded the same level of protection and care, regardless of which type of financial professional they engage. To ensure consistent application of the fiduciary standard, NASAA believes that the pending SEC rulemaking mandated under the Act should apply the fiduciary standard uniformly to all providers acting as advisers in financial services.

While we acknowledge the fiduciary duty limitations in Dodd-Frank, we urge Congress to oppose efforts to adopt a standard that is any less stringent than the Investment Advisers Act

fiduciary standard. Allowing broker-dealers to operate under a reduced standard of care in any phase of their dealings with customers will only increase the confusion that already exists in this area, and such a reduced standard could make it impossible to hold broker-dealers accountable as fiduciaries. Comprehensive standardization of the duty of care applicable to and employed by broker-dealers and investment advisers is necessary and appropriate for the protection of investors.

Department of Labor Defined Fiduciary Duty

A proposed rule by the Department of Labor will cause broker-dealers who offer their services to clients' retirement funds to provide advice through a fiduciary duty model. The rule would put an end to advisers and brokers working with 401(k) plan sponsors avoiding the imposition of a fiduciary duty by either transferring the due diligence responsibility to an outside investment manager or relying on approved lists at their firm. In its comment letter, NASAA commends the Department of Labor for furthering the fiduciary duty standard to its handling of ERISA protected assets, which are often the only form of savings for retirement held by individual investors. We offer support for the proposed rule and urge its adoption. Also, Senator Herb Kohl is crafting legislation to require target date fund managers to take on a fiduciary responsibility in order for these funds to be eligible for the designation of a Qualified Default Investment Alternative (QDIA) in 401(k) plans. Since the Department of Labor designated target date funds as a QDIA, they have experienced an explosive growth in popularity. NASAA supports Senator Kohl's efforts to provide adequate protection against conflicts of interest for investors in target date funds, and we look forward to working with him throughout this Congress.

Core Principle Five: Provide Transparency, Enhance Protections and Reserve Choice of Forum for Investors

Every year thousands of investors file complaints against their stockbrokers. Almost every broker-dealer presently includes in their customer agreements a mandatory pre-dispute arbitration provision that forces those investors to submit all disputes that they may have with the brokerage firm or its associated persons to mandatory arbitration. If cases are not settled, the only alternative is arbitration. For all practical purposes, the only arbitration forum available to investors is one administered by the Financial Regulatory Authority (FINRA).

The arbitration process takes away the ability of a harmed customer to "have their day in court."

Arbitration has been presented to the investing public as an inexpensive, informal, totally private process that results in a speedy resolution of cases. However, the arbitration process takes away the ability of a harmed customer to "have their day in court" by limiting

discovery, reducing the pleading standards, allowing arbitrators on the panels that have conflicts of interest and allowing decisions in which there is severely limited appeal. Arbitration as it exists does not treat the investing public fairly. If the system were fair, arbitration would not be universally required by brokerage firms, and the investing public would embrace it. FINRA's current arbitration rules provide that a panel of three arbitrators must hear all arbitration claims when the amount in controversy exceeds \$100,000. The rules further provide that one of the panel members must be "non-public," which

is defined as an individual who currently or within the past five years has worked in the securities industry. The mere existence of this “industry arbitrator” calls into question the fairness of the forum. Not surprisingly, studies have confirmed the belief that the securities arbitration forum is not perceived as fair to investors, and recovery rates in fact favor the securities industry.

FINRA filed a rule proposal with the SEC in October 2010 that would allow all investors filing arbitration claims the option of having an all-public panel, thus expanding a pilot program to all investor claims. This was an important step toward leveling the playing field for investors and improving the integrity of the arbitration system. However, with the economy as it is today, investor confidence remains very low. Another major step in restoring investor confidence and industry integrity would be to restore investor choice in their agreements with their brokerage firm.

Pursuant to Sec. 921 of Dodd-Frank, Congress should urge the SEC to revisit the issue, prohibit the mandatory nature of pre-dispute securities arbitration, and allow investors the choice they ought to have between arbitration and litigation in an independent judicial forum.

Transparency of PCAOB Disciplinary Hearings and Related Proceedings

The Public Company Accounting Oversight Board (PCAOB) was established by Congress to oversee auditors whose reports are filed with the SEC in order to protect investors and further the public interest in the preparation of informative, fair and independent audit reports on the financial statements of public companies. Adjudicatory proceedings to determine whether an auditor or audit firm should be sanctioned for violating applicable rules or standards are an important component of the PCAOB's oversight authority.

However, unlike the disciplinary proceedings of other, comparable regulators, the PCAOB's cases are non-public until they are appealed to the SEC. NASAA recommends that Congress pass legislation to make disciplinary proceedings initiated by the PCAOB against accounting firms and individual auditors public, unless the PCAOB orders otherwise. The non-public nature of PCAOB disciplinary proceedings has serious adverse consequences for the investing public, audit committees, the auditing profession, the PCAOB and other interested parties. NASAA recommends that Congress enact legislation, proposed by the PCAOB, which would amend the Sarbanes-Oxley Act so that the PCAOB disciplinary proceedings will be open to the public, unless the PCAOB orders otherwise in a particular case.

Increase Protections for Senior Citizens

One of the highest priorities of NASAA's membership is to protect vulnerable investors from investment fraud. Notwithstanding the multi-front offensive launched by state and federal securities regulators, fraud is on the rise and senior citizens remain a target for unscrupulous scam artists. Given the number of baby boomers moving toward retirement who are watching their hard-earned investment portfolios decline in value, it is important that state securities regulators work together with Congress to protect those who will be the most vulnerable to investment fraud.

Fraudulent investment sales to seniors will remain a problem of epidemic proportion as long as the benefits to the perpetrators outweigh the costs. Enhanced penalties for senior abuse—ranging from fines to jail terms—should help to raise those costs, deter law violations and appropriately punish those who exploit senior investors. NASAA supports the Senior Investor Protections Enhancement Act, which places higher penalties on those who target seniors with abusive sales tactics. The legislation, introduced by Senators Herb Kohl and Bob Casey in the last Congress, would impose additional penalties when violations are directed against seniors (62 or older), including administrative penalties of up to \$50,000 and civil penalties up to \$50,000 for each violation. We will work with Senators Casey and Kohl as this proposal moves through the legislative process.

Aiding and Abetting Liability

The Supreme Court has issued decisions that limit the rights of plaintiffs. The Court ruled in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994) that a private right of action under Section 10(b) of the Securities Exchange Act of 1934 cannot be used to recover damages from those who aid and abet securities fraud, only from those who actually engage in fraudulent acts. The Court further eroded plaintiffs' ability to recover from wrongdoers in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2008) by ruling that Rule 10b-5 liability does not exist against those who have no "duty" to disclose to investors. The Court supported its position in *Stoneridge* by pointing out that Congress did not create a private right of action for aiding and abetting in the PSLRA.

The Court's decisions in *Central Bank* and *Stoneridge* effectively insulate a huge class of wrongdoers from civil liability even though their fraudulent actions play a critical role in the securities fraud. As Justice Stevens lamented in his dissent in *Stoneridge*, the Court has been on "a continuing campaign to render the private cause of action under Section 10(b) toothless." 128 S.Ct. 761, 779 (2008).

Section 929Z of the Dodd-Frank Act provides for a GAO study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws.

NASAA urges Congress to carefully consider the findings of this study. The pendulum has swung too far in the direction of limiting private rights of action for securities fraud, rather than protecting investors who have suffered losses. NASAA urges Congress to respect the principle that every wrong should have a remedy, and restore an effective private right of action under federal securities laws.

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