H.R. 2179—THE SECURITIES FRAUD DETERRENCE AND INVESTOR RESTITUTION ACT OF 2003

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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H.R. 2179—THE SECURITIES FRAUD DETERRENCE AND INVESTOR RESTITUTION ACT OF 2003

Thursday, June 5, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:08 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Castle, Manzullo, Kelly, Biggert, Capito, Kennedy, Tiberi, Brown-Waite, Harris, Renzi, Kanjorski, Meeks, Hinojosa, Lucas of Kentucky, Crowley, Israel, Clay, McCarthy, Baca, Lynch, Emanuel, and Scott.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order.

This morning, we are here to conduct a review of the provisions of H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003. We come to this point after an unfortunate period of corporate governance history in which it is apparent that certain managerial officers misused their privileged positions to enhance their personal well-being at the expense of investors and their own corporations.

This is an unfortunate period of corporate performance and required the Congress to act in a forthright manner. To that end, the Congress adopted in rather record-setting time the Sarbanes-Oxley Act which set significant new standards for corporate performance. Contained within that Act was a proposal called the FAIR fund which established for the first time a formal mechanism by which fines and disgorgements proceedings would be returned to the people from whom the assets were taken. Although a new concept, it is not a new method of compensation to defrauded investors. Federal agencies over decades have pursued wrongdoers and utilized mechanisms to provide for investor restitution. This legislation would only provide for an enhanced ability to assist in this important task.

To that end, I want to express appreciation to the NASD having read their testimony, not only for their comments in support of the bill, but in reviewing the performance history of the enterprise. Over history, there have been thousands of times and multi-millions of dollars returned to investors, even without the advent of the FAIR fund, demonstrating not only that it can be done, but that it has been done successfully.

Even NASAA, who has expressed concerns about the legislation in their testimony, has indicated that investor restitution is a laudable goal, despite the attractiveness, I would suspect, of keeping investor dollars for the construction of executive parking lots and DMV offices. Investor restitution is at least a goal we should try to achieve if we can muster the will to accomplish it.

Some have suggested that even if we are to enact appropriate authorities, there may be two significant resource limitations to enable Federal agencies to take on this task. I will propose and be interested to hear the response to the concept of providing that some portion of the fines, penalties and other assets that are acquired be set aside. After investor restitution, after investor education, after any other appropriate action that might be pursued, that the residual funds be placed into the hands of enforcement agencies for the support of these enforcement actions. I cannot understand why that would not be an attractive utilization of these resources.

But as to the other provisions of the legislation which constitute the bulk of the proposal, it will enable the authorities to pursue in a much less fettered way, wrongdoers. If we were to take the cases of Scott Sullivan, Bernie Ebbers, and Tyco's Kozlowski, with the passage of this act, authorities would have unfettered ability to pursue wrongdoers, to retrieve all ill-gotten gains. As to Mr. Sullivan's $20 million-plus mansion, it will have a new for sale sign on it. It says "for sale by owner, the U.S. government." As to Mr. Ebbers's reported estate in Canada, equal in size to the State of Rhode Island, it is going to come back home. With regard to the Kozlowski art and yachts, all gone. Passage of this Act will make sure the art, the yacht, the mansions and even the State of Rhode Island will be returned to its rightful owner.

Let me make it clear: This Act enhances, it does not inhibit, the authorities's ability to act. It does not preclude any State or local regulator from pursuing wrongdoers wherever they may engage in inappropriate conduct. It does provide that the money that is recouped will be given back to the people from whom it was taken.

I also want to express my appreciation this morning to the Consumer Federation. Over the past weeks, we have been in constant communication and negotiation with regard to the provisions of the Act. They have expressed their endorsement of the proposal and have suggested technical modifications on which we have not yet reached resolution, but I am confident that in the coming days we will. We can look forward to a wholesale endorsement without reservation of this important proposal.

In summary, this legislation is essential to assist in the restoration of investor confidence. We give the United States government the authority necessary to pursue wrongdoers, and assure investors we will not stand idly by while fraudulent acts are perpetrated on innocent victims. When the government is successful in achieving conviction and recoupment, we will give it back to the people from whom it was taken. What is more fair than that?

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet today to examine H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act which you recently introduced. As you know, I believe that we have an obligation to ensure the American investors are appropriately safeguarded against cases of securities fraud. I also share your concerns that to the extent possible we should prioritize efforts to compensate investors for losses resulting from securities wrongdoing.

In testimony before our committee earlier this year, the Securities and Exchange Commission suggested a number of legislative reforms needed to enhance its ability to investigate wrongdoing, deter fraud and compensate deceived investors. H.R. 2179 would adopt these meritorious recommendations by permitting the commission to return more of the penalties that it collects to defrauded individuals. It would also increase the commission's power to collect fines, penalties and disgorgements that it orders. Additionally, the bill's provisions to increase access to information and raise fine levels would enhance the ability of the commission to conduct its investigations and deter fraud.

While H.R. 2179 contains all the recommendations proposed by the commission earlier this year, it also contains other additions. I have serious reservations about one of these reforms, Section 8(b). This provision would require State security regulators to remit to the Federal government any penalties or disgorgements obtained from a broker-dealer under certain circumstances. As currently drafted, Section 8(b) poses a number of problems.

Although it may be an unintended consequence, this provision would force a State that has already imposed and collected a restitution obligation to forward any additional penalty that it obtains to the Federal government. In effect, the commission would receive the State's penalty, even though the State arranged for the wrongdoer to provide full restitution to the victims. State regulators have also raised concerns that this provision would significantly limit their ability to craft appropriate remedies like mandating corrective actions in securities enforcement cases.

Moreover, by allowing the Securities and Exchange Commission to take funds from a State, Section 8(b) raises constitutional concerns. I am presently unaware of any other provision in Federal law that allows the Federal government to obtain the money collected by a State in an enforcement action without the State's acquiescence. Because it takes money away, one could also construe this provision as an unfunded mandate on State governments. Historically, our dual securities regulatory system in which Federal and State agencies perform specific investor protection functions has served us well. In recent cases like the online and day-trading scams, penny stock fraud, and investment banking problems with Analyst Research, initial action by the States eventually led to a more comprehensive response by the Federal government.

We should not upset this symbiotic relationship by undermining the incentives or placing fiscal constraints on the ability of States to vigorously pursue wrongdoing in the securities industry. It is therefore my hope that we will remove this provision or significantly revise it when considering this legislation in the future.

While this bill will help to ensure that some investors will receive at least partial compensation for the losses that the incur as a result of securities fraud, I continue to believe that the most meaningful route for investors to receive full restitution for their losses is through private litigation. We therefore need to ensure that investors harmed by corporate wrongdoers can seek legal redress in our nation's courts. As the commission notes in its recent report to Congress, investor lawsuits complement government enforcement action by providing for a mechanism to compensate investors through the award of damages.

While the Securities and Exchange Commission's enforcement actions often have several aims, the objective of private litigation is exclusively to compensate injured investors. Because the ability of investors to fully recover their losses often largely depends on the use of private actions, we need to work to restore the rights of individuals to bring actions against the perpetrators of securities fraud. Amending H.R. 2179 to provide investors with greater access to the courts in cases of securities wrongdoing would achieve this worthwhile objective.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses on this important legislation. I also hope that we will not rush into a markup on H.R. 2179 before we can work together to address issues like improving the access of defrauded investors to the courts and protecting the ability of the States to robustly enforce their securities laws.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 48 in the appendix.]

Chairman BAKER. I thank the gentleman.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

I appreciate your holding this hearing on this important legislation. I think it will send a clear message to all Americans that securities fraud offenders are going to be caught quickly, punished severely, and their ill-gotten gains will be taken away and returned to the injured investors.

Over the past two years, our country has experienced monumental and extraordinary events that have changed the nature of our work here in Washington and shaped our agenda on this committee. No one could have predicted the terror attacks on September 11 or the collapse of several major corporations. With the passage of unprecedented legislation addressing terrorism, reinsurance, anti-money laundering and corporate responsibility, I am pleased to say that this committee stepped up to these challenges. But as the country faces a faltering economy and a war to rid the world of terror, it is even more important that Congress take action to rebuild our economy and address the eroding investor confidence.

We have to continue to ensure that the U.S. investors, now over half of all American families, have the backing and Oversight they need to return the securities market to full-faith and hope for prosperous futures. That is why I feel very strongly about this Securities Fraud Deterrence and Investor Restitution Act, and I am very delighted that we are having this hearing and I look forward to hearing from our witnesses.

Chairman BAKER. Thank you, Ms. Kelly.

[The prepared statement of Hon. Sue W. Kelly can be found on page 50 in the appendix.]

Chairman BAKER. Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman.

The only thing I can add is that obviously I look forward to hearing what they have to say on the priority we all put on the restitution in security fraud as it relates to what is going on. So I look forward to the testimony and the ability to ask questions afterwards.

Thank you.

Chairman BAKER. Thank you, sir.

Mr. Kennedy? No statement?

Mr. Ose?

Ms. McCarthy?

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman.

Again, I will listen to the testimony and then follow through with questions.

Chairman BAKER. Certainly.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman.

I wish to welcome the panelists, and I commend you for calling this worthy hearing. I commend you and Ranking Member Kanjorski.

Over the last two years, we have learned of the many dangers that can plague an unregulated marketplace. We have witnessed the disastrous effects of fraud, corruption and cooked books. Individually, American families lost college savings, retirement funds, and hopes for the future. Collectively, our markets lost the lifeblood of a thriving economy, and that is public trust. In response to these corporate injustices, Congress collectively and on a bipartisan basis passed aggressive legislative reforms to ensure that this devious behavior would not be duplicated.

I believe that H.R. 2179 is a good addition to the Sarbanes-Oxley Act passed last year. I am confident that it will help fully restore our nation's trust in the American marketplace. H.R. 2179 will greatly increase the Securities and Exchange Commission's ability to investigate and deter fraud, levy and collect fines and disgorgement funds, and provide for injured investors. H.R. 2179 will also give the SEC the authority to accept privileged information. This will enhance the commission's ability to access significant and otherwise unobtainable information by allowing private parties to produce privileged or work product-protected documents to the commission without waiving the privilege or protection as against any other party.

For this, I commend you, Chairman Baker and Chairman Oxley. However, I do want to point out a concern that I have. That is the impact with Section 8(b) of this legislation and what it will have on individual States and their ability to combat corporate fraud on a State level. I look forward to working with you on this issue.

Again, thank you, Mr. Chairman. I look forward to hearing the panelists and I yield back my time.

Chairman BAKER. I thank the gentleman.

Mr. Scott?

Mr. SCOTT. Yes, thank you very much, Chairman Baker and Ranking Member Kanjorski. I want to thank you for holding this very important hearing today regarding securities fraud deterrence and investor restitution. To you, Chairman Baker, I applaud you for your hard work on this legislation and on this very timely and important subject.

I also want to thank the distinguished panel of witnesses that will appear before us today, for your testimony on this subject.

Given that President Bush has just signed legislation that would cut taxes on dividends and capital gains, I think that it is very timely for this committee to consider additional investor protections. If the individual investor is not confident that anti-fraud actions have any teeth, they may still have some hesitation to reenter the market at a time when our economy desperately needs that boost. What good is a dividend tax cut if investors are being ripped off?

I believe that H.R. 2179 has many good provisions that will help the SEC investigate and deter fraud and return money to wronged investors. I must admit I do join with some of my other colleagues in having some concerns about Section 8(b). I think that this committee will, after hearing and the questions, will certainly find an appropriate response to the Section 8(b) concerns that I have.

I would also like to focus on one small component of H.R. 2179 that would allow portions of the disgorgement funds established under Sarbanes-Oxley to be used for investor education. While I am a strong believer in preventive medicine and education, as I have worked very hard with this committee and with homebuyer education to prevent predatory lending, and I think the education component for investor education could likewise be beneficial, I would like to ensure that investor education programs are targeted in ways that reach intended audiences and have a maximum impact.

Many Federal agencies, nonprofit groups and private sector firms have public investor education plans. However, I believe that we can improve the delivery vehicle for many of these worthy programs. I would like for the committee to continue to review the standards of investor education curriculum and discuss the ways to help match investors with these programs.

Again, I look forward to hearing the testimony from today's panel, and thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Crowley?

Mr. Lucas?

With that, I would like to welcome our first panel to come forward please. This morning we will have joining us Mr. Stephen Cutler, the Director of the Division of Enforcement for the SEC, as well as Ms. Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight, of the NASD.

Your full testimony will certainly be made part of the record. Feel free to summarize your remarks in 5 minutes.

Welcome, Mr. Cutler.

STATEMENT OF STEPHEN M. CUTLER, DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. CUTLER. Thank you, Mr. Chairman.

Chairman Baker, Ranking Member Kanjorski and distinguished members of this subcommittee, good morning.

I am pleased to be here today to testify on behalf of the Securities and Exchange Commission concerning the Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179. I commend Chairmen Oxley and Baker and the other sponsors of this legislation for their initiative and commitment in introducing this very far-reaching, useful bill. I also thank the subcommittee for holding such a prompt hearing on this significant proposal.

As you know, I testified before the subcommittee this past February concerning the findings and legislative recommendations contained in a number of reports the commission submitted to Congress pursuant to the Sarbanes-Oxley Act. H.R. 2179 incorporates a number of the proposals from the commission's reports which, if adopted, would strengthen the commission's enforcement capabilities and assist defrauded investors.

These provisions would greatly enhance the effectiveness of the commission's enforcement investigations and significantly improve the commission's ability to prosecute securities law violations, collect money from wrongdoers, and return the money to injured investors. I can report that for these reasons, news of this bill has garnered a very enthusiastic response from the staff of the commission's Enforcement Division, who will be eagerly watching its progress.

Although all the provisions of H.R. 2179 are important, I would like to use the remainder of my time to touch briefly on just a few. Section 2 of the bill would improve the commission's collection efforts by eliminating State laws that enable defendants to shield their assets from commission judgments or orders in their homesteads, the so-called homestead exemption.

The exemption arises in commission litigation when a defendant fails to pay quarterly disgorgement and the commission asks the court to hold the defendant in contempt. In contempt actions, defendants often assert that they cannot pay some or all of the owed disgorgement because they lack sufficient assets. As a result, during the contempt proceeding the court must determine which of a defendant's assets are available to pay disgorgement. The court has considerable discretion in determining whether or not exempted assets, such as a homestead, must be used to pay disgorgement.

Currently when trying to collect disgorgement, the commission's staff, at best, must engage in protracted litigation to overcome State law exemptions and, at worst, may be precluded from reaching assets that should be returned to the victims of securities fraud. By overriding State homestead laws, Section 2 of H.R. 2179 would make more assets available for recovery by the commission and for return to defrauded investors, and increase the deterrent value of commission enforcement actions against wrongdoers by depriving them of more assets.

Section 3 of the bill contains several important provisions to strengthen the commission's enforcement program. Section 3(a) would enhance the effectiveness of the commission's cease and desist proceeding by authorizing the commission to impose money penalties in these proceedings. Currently, we have two primary means of seeking civil penalties: administrative proceedings against entities and persons directly regulated by the commission, such as broker-dealers or investment advisers, and in Federal court actions against any entity or person.

By granting the commission additional authority to seek penalties in cease and desist proceedings, Section 3(a) would eliminate inefficiency, give us added flexibility to proceed administratively, and strengthen our ability to hold those who assist in violating the securities laws financially accountable for their actions. The provision also would provide appropriate due process protections for subjects of these proceedings by making imposition of a civil penalty in an administrative cease and desist proceeding appealable to the Federal Court of Appeals.

Section 3(b) would significantly increase the amount of penalties that the commission may seek for violations of the Federal securities laws in many types of actions. Increasing the size of penalties is an important step in achieving the desired deterrent effect under the securities laws. In addition, by using the FAIR fund provision in Section 308(a) of Sarbanes-Oxley, the commission may more fully compensate injured investors if larger penalties are paid.

Section 4 would allow a person to provide privileged information to the commission without waiving that privilege as to other persons. If adopted, this provision would help the commission gather evidence in a more efficient manner by encouraging parties under investigation to voluntarily produce to the commission important information that otherwise could be withheld. Section 4 would help us conduct more expeditious investigations and contribute to quicker enforcement actions with a greater likelihood of recovery of assets for investors.

Section 5 of the bill would enhance the commission's access to grand jury information. Specifically, it would authorize the Department of Justice subject to judicial approval in each case to share grand jury information with the commission staff in more circumstances and at an earlier stage than is currently permissible. The judicial approval would be based on a finding of the commission's "substantial need to be informed." Federal and State financial institution regulators already have the kind of access to grand jury information that Section 5 would provide to the SEC. Enacting Section 5 would make it possible for us to efficiently and effectively receive timely information required to complete our investigations and prosecutions, and avoid unnecessary duplication of government efforts.

Now let me skip to Section 8 of H.R. 2179. It contains substantive amendments to the FAIR fund provisions. Section 8(a) would amend the provision by allowing the commission to use any penalties paid as a result of commission actions to compensate investors injured by defendants in such actions. The FAIR fund provision was a groundbreaking measure to help the commission return more funds to defrauded investors. It did so by changing the law to permit penalty amounts collected to be added to disgorgement funds in certain circumstances.

The commission has begun to make ample use of this new authority. To date, we have sought creation of 27 FAIR funds for investors and the disgorgement, and penalty amounts covered by these 27 actions total almost $990 million. I am confident that we will continue to regularly use this provision in the future for the benefit of investors.

Section 8(a) would expand the application of the original FAIR fund provisions so that even more penalty dollars may be made available to harmed investors. As enacted, the provision only permits the commission to add penalty amounts to disgorgement funds when a penalty is collected from the same defendant that has been ordered to pay disgorgement. Section 8(a) eliminates this restriction so that all penalties may be used to create a FAIR fund, whether or not disgorgement also is ordered.

Section 8(b) provides that if a State establishes by agreement or judgment a requirement for brokers or dealers that is different from the requirements of the Federal securities laws, then penalties or disgorgement paid as a result of the agreement or judgment shall be remitted to the commission for distribution to injured investors pursuant to the FAIR fund provision.

Congress long ago created a dual securities regulatory system in which both Federal and State agencies serve specific valuable functions in protecting investors. At the same time, there is little question in my mind that the imperative to achieve consistent regulation of the U.S. securities markets dictates the need for a single dominant national regulator. This is not meant to suggest that the States should be relegated to the backseat of our regulatory system. State securities agencies have played and should continue to play a significant role in making our securities markets the most respected and trusted in the world. The more resources, both Federal and State, we can bring to the cause of maintaining this status, the better off investors are.

During the past year, the overlapping responsibilities of Federal and State agencies have been vividly illustrated by the joint investigations of research analyst practices undertaken by the commission, the self-regulatory organizations, and the States. The commission believes it is important to return funds collected through enforcement actions to harmed investors whenever possible and at all levels of government, Federal, State and local. For this reason, the commission and other Federal regulators determined to use their portion of the monies obtained in the Global Research Analyst settlement to recompense investors.

Moreover, we invited the States participating in the settlement to contribute their portions of the settlement payments to the Federal distribution fund as well. Thus far, one State, the State of Missouri, has responded affirmatively to our invitation and has expressed an interest in working with us to distribute disgorgement and penalty amounts to investors. The policy question of whether Section 8(b) strikes the appropriate balance between State and Federal securities enforcement power is appropriately Congress's and not the SEC's to resolve. Nevertheless, the commission strongly supports the concept of investor restitution and we are eager to work with the subcommittee to facilitate reimbursement of harmed investors from the broadest possible array of sources.

In conclusion, the commission strongly supports congressional action to improve the commission's enforcement capabilities. The proposed Securities Fraud Deterrence and Investor Restitution Act would greatly assist the commission in fulfilling its enforcement mission to prevent, detect and prosecute securities law violations and to provide recompense to injured investors. We look forward to working with this subcommittee in the future to further these important goals.

I would be pleased to answer any questions the subcommittee has.

[The prepared statement of Stephen M. Cutler can be found on page 60 in the appendix.]

Chairman BAKER. Thank you, Mr. Cutler. We appreciate your appearance here today.

Our next witness is Ms. Mary Schapiro, Vice Chairman and President, Regulatory Policy and Oversight from the NASD. Welcome.

STATEMENT OF MARY SCHAPIRO, VICE CHAIRMAN AND PRESIDENT, REGULATORY POLICY AND OVERSIGHT, NASD

Ms. SCHAPIRO. Thank you, Chairman Baker, Ranking Member Kanjorski and members of the committee. I appreciate having the opportunity to testify today on this very important legislation.

NASD believes this bill will strengthen the enforcement hand of the Securities and Exchange Commission at a time when more than 85 million American investors are looking to regulators, legislators and industry leaders to meet our collective responsibilities to protect investors and strengthen market integrity. Toward that end, we endorse the bill's twin goals, for we believe it will both maximize the amount of restitution that is returned to investors and strengthen our nation's system of securities regulation.

I believe this bill can have a third important affect on investor confidence and the culture of corporate America. That is to change significantly the calculus by some companies and executives who seem to believe that paying SEC penalties is not a sign that they have abused investor trust, but rather just another cost of doing business.

As you know, NASD is the world's largest securities self-regulatory organization. Virtually every brokerage firm in the country that does business with the U.S. public must, by law, be a member of NASD. With a staff of 2,100, more than a dozen district offices throughout our country, and an annual budget of $400 million, we touch nearly every aspect of the securities business. By providing a layer of private sector regulation between the SEC and the brokerage industry, NASD is not only a guardian for investors, but also a bargain for taxpayers.

I am particularly pleased to be testifying with my colleagues from the SEC and NASAA. In the U.S. system of securities regulation, each of us plays a vital role. The SEC has overall responsibility for setting the national structure of securities markets and regulation. The SROs, including NASD, set and enforce rules for the day to day operations of the markets and the brokerage industry. The State Securities Regulators are our invaluable partners in licensing and enforcement, adding more cops on the beat at the local level.

All three sets of actors, SEC, NASD and its sister SROs and the States, need the proper mandates and tools to do their work effectively. All three, for example, were critical to achieving the recent $1.4 billion Global settlement with the large Wall Street investment houses. In developing and finalizing that settlement, we sought to underscore four basic principles: one, to change the way Wall Street does business; two, to get maximum recovery to investors using the FAIR fund; three, to fund investor education in effective and innovative ways; and last but not least, to make certain that the evidence we uncovered would be made available to harmed investors so they would be able to seek recovery of their losses through meritorious arbitrations and court proceedings.

At NASD, we believe that an important part of restoring investor trust is to ensure and demonstrate very publicly that where wrongdoing is uncovered and proven, significant fines will be collected and channeled to greater enforcement efforts, enhanced regulation and through restitution to investors. H.R. 2179 furthers the goals of maximizing restitution to investors and arming the SEC with additional tools to quickly and effectively combat securities fraud.

In this same vein, NASD also welcomes the provisions of H.R. 2179 that will strengthen the SEC's ability to pursue violators and increase opportunities for investors to recoup losses due to fraud. In particular, I would note the elimination of the homestead exemption that will be helpful to investors as they attempt to collect from those who have defrauded them. This will stop illicit profits from winding up in the pockets of wrongdoers, while investors' pockets remain empty. This is an important provision for solving the corrosive and perennial problem of crooks building massive homes to shelter ill-gotten gains from injured investors.

Mr. Chairman, NASD is pleased to testify in support of this legislation. We remain committed to working with your committee and with our valued partners in securities regulation to bring integrity to the markets and confidence to investors.

Thank you again for this opportunity and I would also be happy to answer any questions you or your colleagues have.

[The prepared statement of Mary L. Schapiro can be found on page 80 in the appendix.]

Chairman BAKER. Thank you very much.

Mr. Cutler, the SEC prior to Sarbanes-Oxley obviously had been involved in investor restitution and recoupment of ill-gotten gains for decades. With the passage of Sarbanes-Oxley in the course of the year in which the FAIR fund has been created, you have indicated there are 27 funds now created, with the potential of $990 million of restitution potentially made available. Is that correct?

Mr. CUTLER. I believe that we have made motions in 27 different actions. I do not believe we have yet gotten court approval in all those actions. Indeed, I can tell you that one of the very significant actions where we are seeking court approval is in the WorldCom matter, which involves $500 million of the $990 million that I referred to before. But it is absolutely right that we are seeking to use this provision wherever we can to get money back to investors.

We think it is very significant and a terrific thing that you and this subcommittee and Congress have done for investors.

Chairman BAKER. Subject to court permission, then, you do not view mechanically a problem in providing for the distribution of those funds, subject to court approval to do so?

Mr. CUTLER. Not at all. Again, you are absolutely right. It is what we have always done, always sought to get disgorgement payments back to investors. What this legislation allowed us to do was to try to enhance the amount of money that was returned to investors by allowing us to combine disgorgement payments with penalties.

Chairman BAKER. With regard to the comments referencing 8(b), getting to the heart of the matter, if a State regulator were to pursue a wrongdoer and find that wrongdoer, and not as a consequence change market structure, that fine would be retained by the State. Would it not?

Mr. CUTLER. Under the proposal as I understand it, yes, sir.

Chairman BAKER. So that it would only be in a tandem action where the regulator would affect Federal securities law governance, and a fine being imposed, that the funds would be forwarded from the State regulator to the SEC to be disposed of through the FAIR fund. Is that correct?

Mr. CUTLER. Yes, although as I understand the proposal, it is not always the case that actions that States bring are in tandem with those of the Federal regulators.

Chairman BAKER. My point is not in tandem with the Federal regulator. It could be a unilateral action by a State regulator, but as long as the action does not affect Federal market structure, then the fine collected is retained by the State. It only is applicable with regard to Federal statutory market function and fine. A State regulator could enter into a voluntary agreement with a wrongdoer that does affect market structure, as long as they were not fined. What is it, then, that inhibits a State regulator from taking action if this bill were to become law?

Mr. CUTLER. I don't know, and it may be nothing. Probably Ms. Bruenn is in a better position to answer this than am I. I know that one of the technical concerns that the States have in connection with this proposal is whether the monies could be returned if some sort of FAIR fund were set up for investors of those States.

Chairman BAKER. Correct, but my point being, let's go to the Merrill settlement, for example; $50 million went to New York. There has never been anything represented to us that half of these defrauded investors resided in New York. If we are trying to get to a national policy that provides recompense in relation to the people who were wronged, the idea is that if you are going to change market structure and fine, then let's distribute the resources where the people are, as opposed to an objection to having the compensation kept by the State that initiates the action, not with regard to where the investors are domiciled.

If I had anybody explain to me how the $100 million distribution was made that was relative to some formula or study of participation by investors, it possibly might make sense. The NASSA, for example, received $2 million of that settlement. I would be interested to find out on what basis that allocation was made. It is not even a State, I don't think.

My point being that the current methodology for distribution of compensation does not have a rational nexus to the act itself. If we do not preclude States from pursuing wrongdoers; you can keep the money if you do not change market structure; you can change market structure and not levy a fine; you can do both and provide that the money go back to the people from whom it was taken.

Ms. Schapiro, NASD has done this as well. Do you have observations of any technical inhibitions to your ability to provide compensation to wronged investors in actions of the NASD in prior years?

Ms. SCHAPIRO. No. We have made returning funds to investors a high priority in our enforcement program. To date this year, there have been 33 cases in which restitution has been ordered by the NASD to firms to grant to investors. We share the goals, I believe, of this entire committee that we maximize on return to investors through restitution.

Chairman BAKER. And NASD has done this for many years, I presume?

Ms. SCHAPIRO. Yes, we have done it for many years and it will continue to be a priority whenever we do an enforcement action to look to identify victims of the wrongdoing and maximize return to those victims. It is not always possible, but that is our goal. Where it is not possible, fine money is devoted and dedicated to expanding enforcement capability and our regulatory abilities.

Chairman BAKER. Thank you. I did not realize I had long exhausted my time. I want to come back.

Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, I am certainly willing to wait for any further questions you have.

Chairman BAKER. Maybe I can get somebody to yield time. That is all right.

Thank you, Mr. Kanjorski.

Mr. KANJORSKI. Mr. Cutler, you obviously have not been the proposer of Section 8(b), but you seem to agree with the chairman's and probably even my desire that there be some national standard and fairness in distribution. But have you considered some of the unintended consequences of 8(b)? For instance, suppose that the SEC at some future date is not aggressive. What is the incentive for States to proceed in the absence of an aggressive SEC when they would have to bear the expense of the pursuit of these fines and disgorgement and would not even be compensated for their expense?

What I relate to is in the Federal government between the various departments we have this problem. I will give you an example I worked on several years ago that still happens to be constant today. Nothing has been done. In the Department of Energy there is about $50 billion worth of surplus equipment and property. Under existing law, if the department proceeds to sell or handle or dispose of that property, they have to spend it out of their departmental budget.

On the other hand, when they sell that property or dispose of that property, it does not come to the Department of Energy, but goes into Treasury directly. As a result, there is a disincentive for them to get involved in disposing those surplus and excess properties. I am just analogizing that situation as a disincentive.

Why would an Attorney General of a State or a securities exchange commission on a State level expend their budget and assets to pursue a wrongdoer when in fact they will receive none of the benefits from their success, but get all of the detriment and expense of pursuing it, not only the expense of that individual case where they are successful, but will be short-changed in pursuing other cases that they may not be successful in, and therefore further erode their budgetary considerations in the commission itself or in the Attorneys general office of the various States? How do we resolve that problem?

Mr. CUTLER. First, I want to take issue with the predicate for your question. It is hard for me to imagine that we will not be aggressive, so let me start there because that is where you started.

Mr. KANJORSKI. We have to assume that, not this SEC, but some future SEC just sits on its hands. It is always possible in government.

Mr. CUTLER. I did not think you were talking about this SEC.

Mr. KANJORSKI. Right.

[LAUGHTER]

Mr. CUTLER. So let me take the rest of your question. Why would a State continue to proceed, push forward to prosecute a violation if the money that they extracted was not coming into their coffers? Actually, the analogy that I thought of was actually the SEC. None of the money that we have ever collected in fines or disgorgement has been tied to our budget. Indeed, I think in some ways that has been very healthy because it means that we are pursuing wrongdoers not because somehow it would enhance our coffers, but because it is the right thing to do and that is our mission.

In no way has the lack of any nexus between what we have collected and what we are budgeted at deterred us or precluded us or discouraged us from seeking to go after wrongdoers. It is hard for me to imagine that any State securities regulator or any State prosecutor would be deterred or precluded or discouraged from going after wrongdoing because the money was not going into that regulator's back pocket. I think our State regulators are too professional to think that way.

Mr. KANJORSKI. You just do not believe that there would be any budgetary considerations, and therefore the analogy I gave of the Department of Energy, they are unique, in fact, that they are not pursuing a good public policy to recoup $50 billion of property that they have no use for because it would take directly from their budget? That is a unique department of government, do you think?

Mr. CUTLER. All I can speak to is the experience that we have had at the SEC as prosecutors, and that consideration does not enter into our calculations.

Mr. KANJORSKI. I understand that, and of course you had a lenient Congress to be willing to appropriate and double the appropriations for the Securities and Exchange Commission, but that may not be true on a State level. I do not imagine that the budgets of State Securities Exchange Commissions are as robust as the Federal budget. Secondly, there very often may be a difference of political affiliation between the Chief Executive of a State and the Attorney General.

What he expends his budget on may be very important in terms of not expending it on a situation where the recovery would not justify his expense to his own budget in continuing prosecution, and in fact would only be working for the benefit of the Federal government or the national Securities and Exchange Commission. He may have a very hard time justifying in a small State why he is spending one-third of his budget in the pursuit of securities actions and therefore having to ignore other prosecutions when none of that money will be recouped.

Now, in the ideal world, I think you are probably right. All prosecutors do not consider budgetary considerations, but maybe I have had a terrible experience sometimes with district Attorneys and Attorneys general at the State level that that does become significant, as it is in the Department of Energy, I mean, with a huge problem. We have just not been able to force them to get rid of their excess property and allow the government to use it generally because we have not incentivised them; we have actually penalized them. You do not see that potential as an unintended consequence of Section 8(b)?

Mr. CUTLER. I understand the concern. I take the chairman's point that we are only talking about in this proposal a very narrow slice of what it is that States do in securities enforcement actions. That is, you could probably count on a couple of hands actions that are brought where both restitution or penalties are sought, and relief is imposed that would require a broker-dealer firm to establish policies that go beyond the Federal securities laws.

So I do not know if I have the concern as acutely as you do, Mr. Kanjorski, but I do understand the concern. I think there are complicated policy questions here, and it is probably not my purview to say what it is that would happen as a result of the State budgeting process. I can imagine that to the extent that States were returning money to investors in their States, that might actually put them in a position to achieve a greater budgetary allowance for the securities enforcement mission.

Mr. KANJORSKI. Obviously, it is a concern of mine and I have heard it expressed in several of the opening statements, particularly Section 8(b). Could we extract from you an agreement to work with the State regulators to refine Section 8(b) in the immediate future so that if it is worthwhile, and it may be, it can be acceptable to some of us that have concerns, and particularly with the State regulators? Maybe something can be definitively worked out from the Federal SEC with the State regulators.

Mr. CUTLER. I cannot speak for the commission, sitting here, but I think it is a terrific idea that we work with this subcommittee, as well as the SROs and the States, to figure out the parameters to the extent that there are technical issues with respect to this approach, that we figure out a way to work them out. I think that is a terrific idea.

Mr. KANJORSKI. I appreciate that, Mr. Cutler.

Chairman BAKER. Thank you, Mr. Kanjorski.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Cutler, I am a little confused about some of your comments. I have some prior testimony that was submitted, and then I have some testimony that I picked up this morning. This is in relation to Section 8(c). You say in both pieces of testimony, it is important to determine how it would affect incentives to and fiscal constraints on a State's ability to pursue securities related misconduct aggressively and vigorously. And then you speak of technical drafting issues. I am interested in your prior testimony because you outlined a couple of technical drafting problems.

I am also concerned, as Mr. Kanjorski is, about the effective regulation with regard to this, and the dialogue between the States and the SEC. Do you want to elaborate on that a little bit? Then I have one more question I would like to ask.

Mr. CUTLER. Sure. I think we share the twin goals of Section 8(b). We had referred to it as Section 8(c). The twin goals are getting as much money back to harmed investors as possible. I think that is probably a goal we share with the States. Also to the extent that the provision speaks to this, the need for a single dominant national regulator when it comes to issues of our national market system.

Indeed, I was on a panel yesterday with Mr. Spitzer from New York, not a panel before Congress, but speaking session, and he agreed that when it comes to reforms that change how the national market system works, it is incumbent upon the States to work with the Federal government to ensure that we do not have balkanized markets. It seems to me and it seems to the commission that those are the twin goals of Section 8(b). To that extent, we are very supportive of Section 8(b).

Yes, there are some technical issues; and yes, there are issues about what kinds of incentives this creates or disincentives it may create that Mr. Kanjorski pointed out. That is why I think it is important that we work with the States and with this subcommittee, and with the SROs, to come up with an appropriate and effective way to implement the twin goals of Section 8(b).

Mrs. KELLY. In your testimony, you spoke of the commission inviting States to participate in the Global settlement, that they would contribute their portions of the settlement payments to the Federal distribution fund. And just now, speaking to Mr. Kanjorski, you gave a rather ringing endorsement of State regulators. Yet, you are also experiencing, I believe, some reluctance from the States to work with the SEC and with the Federal distribution fund, I believe. Is that not true?

Mr. CUTLER. It is true. We extended an invitation to all of the States and we have to date heard from a single State that is prepared to work with us on distributing money back to investors.

Mrs. KELLY. Why do you think that reluctance exists?

Mr. CUTLER. In some cases, as I understand it, the State statutes themselves do not provide for State restitution when it comes to penalties. So one of the things that is very helpful in connection with Section 8(b) and the approach that Section 8(b) takes is a way to overcome those hurdles.

Mrs. KELLY. Do you feel that because we have set up the Federal distribution fund, do you feel that the States are reluctant because they need the float currently? Do you think that situation might change?

Mr. CUTLER. I just do not know. I have heard about the statutory hurdle. I know that one concern of States, and I appreciate this concern, is any money that they have collected be returned to citizens of their State. That is something we told the State of Missouri that we would work with them on, but I cannot speak to other potential concerns because I have not heard any.

Mrs. KELLY. Do you feel the SEC is prepared to work with all 50 States and would return that money to the individual States's investors, because administratively, that could be quite a bit for you.

Mr. CUTLER. Again, that is something that we are going to work on with the States. It is administratively difficult. But to the extent that it is practicable, we understand the issue and we respect the issue and would like to try to accommodate the States in connection with that concern.

Mrs. KELLY. Certainly, my personal feeling is that any way that we can possibly rapidly get the money back to the investors that they are owed because of decisions, that needs to be done. We need to grease those skids. My concern with regard to what you are saying is that I would like to have the SEC take a look at which way is actually going to be the fastest, whether it is State redistribution of the funds or Federal. But I think that what we need to focus on is the speed with which those people can get their money back once these adjudications are made. I hope you will look at that.

Mr. CUTLER. I share your concern, Representative Kelly. I think it is important to do this as quickly as possible.

Mrs. KELLY. I do not think investor confidence is going to be improved until and unless we have some mechanism quickly in place to return the money. People need to have faith that if they are caught in a situation, as some of these people have been, with basically malfeasance on the part of some of these people, the investors need to know they can be made whole and swiftly.

Thank you very much, Mr. Chairman.

Chairman BAKER. The gentlelady's time has expired.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

I wanted to ask about the role of the States. To what extent have States failed to return money to the investors, and have instead used the money for their general fund? I am a former State senator and rules chairman. I have worked with budget committees and I know that in the State when these funds are undedicated, they see that as free money. I was wondering to what extent have they failed to return the money to investors. That is the first part of the question.

Mr. CUTLER. I do not want to overstate the problem, Representative Scott. Indeed, I believe the States typically are very concerned about getting restitution payments to investors. When it comes to the penalty portions of what they collect, I think the story may be slightly different. Again, I should let Ms. Bruenn speak to this when she follows with her testimony.

I do know that in the Global Research Analyst settlement, again to repeat what I said earlier, we have only heard from one State that is interested in returning its portion of the penalty and disgorgement payments to investors. I just do not know if that is indicative of the approach that the States take in other matters.

Chairman BAKER. Would the gentleman yield in response to his question?

Mr. SCOTT. Sure.

Chairman BAKER. I just happen to have a sheet relative to the Global settlement distribution. New York, Texas, Kansas, Massachusetts, Maine, Colorado, Arizona and New Hampshire did an unqualified allocation to the general fund. Utah did an education fund first, but any funds remaining over $100,000 at the end of the year went to the general fund. Washington State puts most of it in the State treasury, but a portion is going to go to the Securities Enforcement Division at the State level. Missouri is joined with the SEC in a restitution effort at the national level. Virginia is doing a DMV construction and loans for school construction. And Nebraska is going to endow a chair in its State university. So generally speaking, and I appreciate the gentleman yielding, it has not gone to restitution for any number of reasons.

I thank the gentleman for yielding.

Mr. SCOTT. Thank you.

Chairman BAKER. Does the gentleman yield back, or do you wish to continue? I am sorry. Thank you, sir.

Mr. Manzullo?

Mr. MANZULLO. Thank you very much.

I have some questions with regard to what could be some extraordinary remedies the SEC is seeking and perhaps you can help me on this. If the IRS obtains a judgment against an individual, does the law say the IRS lien will override a homestead exemption?

Mr. CUTLER. I do not know the answer, Representative Manzullo.

Mr. MANZULLO. Do you know of any laws that preempt the homestead exemption?

Mr. CUTLER. With respect to other areas of the law, I just do not know, Mr. Representative.

Mr. MANZULLO. I think this is extraordinary. I think that is something you ought to check on. The State of Illinois, when I practiced law, I have been here for 10 years, the homestead exemption was only $7,500 for an individual. Did somebody give you the answer on that on the IRS lien?

Mr. CUTLER. I am sorry?

Mr. MANZULLO. I am sorry. I thought somebody behind you whispered the answer on that.

The remedies you are seeking only apply to a judgment that is obtained at a District Court. Is that correct? Or are you trying to give an order of the SEC the same efficacy as a court judgment?

Mr. CUTLER. I would have to look back at the legislation. I know it applies to Federal court judgments. I just do not know whether it applies to administrative proceedings as well.

Chairman BAKER. Would the gentleman yield on his question for a moment?

Mr. MANZULLO. Yes.

Chairman BAKER. The way in which Sarbanes-Oxley passed, it did in fact affect the homestead exemption at the State level, based on the presumption that securities fraud ill-gotten gains were dumped into houses pursuant to a State's homestead exemption protection. However, there is an intervening step which may be taken by filing bankruptcy which precludes, then, your ability to go after the home once you are under the protection of the bankruptcy. What this provision would enable us to do is to go after the asset regardless of a homestead provision or a bankruptcy proceeding.

So the gentleman is correct that this is an extraordinary remedy, but there has been a case in the past where the Congress has acted to lower the protections of the homestead exemption.

Mr. MANZULLO. I think this needs to be taken a second look at, because number one, it is preempting all State laws. Traditionally, the common law exempted a horse, which has been interpreted by the State of Wisconsin to mean an automobile, a means of conveyance. It has exempted personal effects, wedding rings in the State of Illinois, and a homestead with a very modest amount. What you are saying is that your judgment is more important than judgments for back child support, for unpaid alimony, for families of people who are killed by drunk drivers, and places this ahead of every other judgment that is out there, and really does violence to the whole purpose of the homestead exemption.

I think that is very roughshod. My suggestion would be maybe allowing a constructive trust to be placed on a homestead. In other words, if you can trace that the defrauded money was used to buy the residence or to pay down a mortgage, then to the extent that you could trace it, that would allow you to actually go after at least that portion of the homestead.

One of the examples you used here also would wipe out an innocent spouse's right to keep the homestead. If I am reading the example that you set forth on page five, citing this SEC v. Great White Marine case, where apparently you were upset with the fact that the innocent spouse was allowed to keep one-half of the equity in the homestead. This Congress about three years ago passed a provision insulating innocent spouses from the IRS lien whenever the spouse who had actually defaulted on his or her taxes ended up with a judgment. Do you recall that Chairman Baker? It was the Taxpayers Bill of Rights, I think, that we called it.

Are you saying that the innocent spouse would lose his or her homestead right in the property?

Mr. CUTLER. No. As I understand it, that is not the purpose of the legislation. Really, what we are talking about is the right of someone who has committed fraud to step in ahead of victims and keep the money, keep it sheltered in a mansion, as opposed to disgorging it and giving it back to harmed investors.

Mr. MANZULLO. Okay. I can understand, but I would suggest there is a better way than simply saying SEC judgments will override homestead laws, and allow the court to set up a constructive trust. You know what that is, where you follow the trail of the money. Because at that point, you are still protecting the homestead right, while following the money, if somebody stole $1 million and took that $1 million and put it into a homestead. Do the courts, in your understanding, have the ability to set aside that homestead now to the extent that the defrauded money was put into the homestead? Or is that the remedy that you are seeking?

Mr. CUTLER. That is the remedy that we are seeking. With respect to penalties, we do not have any ability to break through the homestead exemption, and with respect to disgorgement, it is very limited and requires substantial litigation.

Mr. MANZULLO. But does the legislation specifically require the tracing of the defaulted money to the particular property?

Mr. CUTLER. It does not, and I think for a very good reason. The very good reason is that money is fungible. Yes, would it be helpful to get the power to break through the homestead exemption when you can trace the money? Sure, that is more than we have now. But I would submit to you that it is not enough, Mr. Manzullo. The reason is because it is very easy for someone to put the money somewhere else and then go buy the big mansion. Because money is fungible, I do not think a provision that is limited to a tracing provision would be as effective as this subcommittee would like and we would like.

Mr. MANZULLO. I do not know if the subcommittee is satisfied. I have very deep serious questions over simply coming in and saying the SEC order or final judgment is more important than an order for back child support, orders for victims of drunken driving cases, or orders for other common law or statutory frauds that are taking place. I mean, this is extremely serious when you are going to preempt those homestead laws.

We went through that in the bankruptcy reform. If I recall, I am not sure if there was a provision allowed in there as to a monetary amount or as to the State, but what you are saying is that you would come ahead of all other classes of creditors involved, for example, in a bankruptcy in going after to try to find the homestead.

I would think you might be better off working on the provision to allow that constructive trust. I do not think it is that difficult. If somebody stole millions of dollars and then after the fraud has taken place, they have gone out and bought a brand new home, what is so hard about that, to say that the home was purchased after the money was stolen?

Chairman BAKER. I am sorry. I am just waiting for the gentleman to conclude. The gentleman's time has expired.

Mr. MANZULLO. Thank you.

Chairman BAKER. Mr. Emanuel?

Mr. EMANUEL. Let me ask you, on this homestead exemption, do you have a dollar figure? What is the revenue size here? What is the cost that we are looking at?

Mr. CUTLER. I do not have that information available.

Mr. EMANUEL. Is there any guesstimate out there besides from you that you could call, say a reputable organization?

Mr. CUTLER. We can try to get that information.

Mr. EMANUEL. One of the things that would be helpful here is to bring this down to some brass tacks, so that we understand what the size is that we are dealing with here. Not that this is not a relevant discussion; sometimes those irrelevant discussions are up in the air. But what in fact is the dollar figure that is at stake here? What is the cost here that we are dealing with? Nobody has ever put a guesstimate together, to your knowledge?

Mr. CUTLER. Not to my knowledge, but why don't we try to do that, Mr. Representative.

Mr. EMANUEL. Okay. That would be helpful.

Question whether requiring remission of penalties obtained by a State where remedial actions are ordered, will it weaken State security law enforcement efforts? Do you know that?

Mr. CUTLER. Excuse me, I did not hear.

Mr. EMANUEL. Whether requiring remission of penalties obtained by a State where remedial actions are ordered will weaken State securities law enforcement efforts. What is your view?

Mr. CUTLER. Again, in my view, no responsible State prosecutor, no responsible prosecutor at any level would make decisions about whether to go after misconduct on the basis of whether the money was coming back to the coffers of the State or not. Having said that, I understand that there may be some complicated budgetary issues that I know Ms. Bruenn will speak to as well, and this subcommittee will consider. For the most part, they are beyond my area of expertise.

Mr. EMANUEL. Thank you. No further questions.

Chairman BAKER. Thank you, Mr. Emanuel.

Ms. Harris?

Ms. HARRIS. Thank you, Mr. Chairman.

I don't think anyone can argue with the concept of homestead preemption clause that has been included in this legislation to make sure that fraudulent funds are not harbored in multimillion dollar mansions. But I have grave concerns as you attack the homestead exemptions. In the State of Florida and many other southern States, these were originally conceived to protect mama at home with the children. I really want to associate myself with the gentleman from Illinois's comments because it just strikes me as such a big government oppressive approach.

Certainly, the tracing provision may not get you as close to it as you need, but to go in when there is an innocent spouse with children and home, and basically take that homestead, which is really considered sacred in the States of Florida and Texas and some 15 other States. Many States do not have that provision and so it does not cause the angst, but this is something incredibly important.

There has already been a crack in that homestead exemption, Mr. Chairman, in the bankruptcy bill where they have already attached a provision concerning homestead, cracking that initial issue. I am just extremely concerned that we move forward with this. I think it requires a lot more interest and effort, I can tell you, from the States that really consider homesteads that sacred issue.

You do have vendors's liens. You do have a mechanic's lien. But just in terms of the mortgage laws, in order to get a mortgage, all of these kinds of things in some of these States, you are going to change the course of financing across-the-board when you are setting the SEC first in terms of being able to collect these funds in going after homesteads. So I have grave concerns about the homestead clause in this bill.

Chairman BAKER. Does the gentlelady yield back?

Ms. HARRIS. Yes, Mr. Chairman.

Chairman BAKER. Ms. McCarthy?

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman.

I think with the questions that we are seeing, I mean, that is the whole idea of having a subcommittee hearing, so that we can hopefully work these things out. I think overall, the goal of the bill has its very good merits. Obviously, you have heard a number of us talking about our concern about the States.

In your testimony, you indicated that with respect to Section 8(b) of the bill, that Congress created a dual securities regulatory system in which both State and Federal agencies serve specific valuable roles. You testified that the question of whether this section strikes the appropriate balance between the State and Federal securities enforcement power is Congress's to resolve.

You also recommend that this issue may require further study, given that the FAIR fund provision has been in effect for less than one year, and that distribution of funds under the Global settlement, as you testified, may yield important lessons.

I guess my question is, and we talked about this earlier when you answered a question, how long would such a study last and who would conduct the study? Can you give me some specifics on the suggested study of what you would even be looking for?

Mr. CUTLER. The only thing I think we were trying to suggest is that we have only had I think it is about 10 months worth of experience with the FAIR fund provision. You are probably in a better position to make the judgment as to how much experience we need with that provision. Again, I thought Mr. Kanjorski's suggestion that we work together with the States and the subcommittee to see if we can come up with something workable was an excellent one.

Mrs. MCCARTHY OF NEW YORK. The other thing, and again I know an awful lot of my State Attorneys or Attorneys general that certainly will continue to work, but obviously with the economic climate that is out there, my fear is would they back off on certain types of prosecutions through SEC if they do not have the money. I mean, their funds are going to be cut like everybody else's because most States are mandatory. They have to meet their budget. It is not like here where we can just raise the budget ceiling. So I have a concern about that and I think that we have to, before this bill goes forward, try and work out something that we can guarantee that the States and the Federal government will work together.

Thank you.

Chairman BAKER. The gentlelady yields back.

Mr. Tiberi?

Mr. TIBERI. Mr. Chairman, I will yield my 5 minutes to the chairman.

Chairman BAKER. I thank the gentleman for his insightful judgment.

[LAUGHTER]

I want to return to the issue just raised by the gentlelady and others with regard to the ability of a State Enforcement Authority to pursue wrongdoers and the disposition of the fines, penalties or disgorgements generated. As Section 8(b) is constructed, I am the Attorney General of Louisiana, and I am pursuing Corporation X and I get them. We collect $100 million. Those are the terms of the deal. We do not affect market structure at all. Give me the money;

I get to keep it; the State gets to keep it; and I can go out and build all the parking lots I want.

Is that your understanding of how the current Section 8(b) would function, Mr. Cutler?

Mr. CUTLER. Yes. It is a very narrowly crafted provision. It only applies when the State both seeks money and a remedy that would require a broker-dealer firm to go beyond the current requirements.

Chairman BAKER. The current Federal regulatory structure.

Mr. CUTLER. That is right.

Chairman BAKER. Now, the reason for that being constructed in that fashion is to retain the SEC's primacy in Federal regulation of securities transactions. That means if the State regulator chooses to pursue someone and simply wants to change market structure, whatever that might be, however they choose to do, separating investment banking from something else that might be problematic, they can do that, but they cannot also levy a fine without distributing those proceeds back through the FAIR fund to the defrauded investor. Is that your understanding?

Mr. CUTLER. It is, although I hope that if they do pursue market structure reforms, they will also come and talk to us. I think over the past year, we have developed a good enough relationship where I hope and am optimistic that that would happen.

Chairman BAKER. Good luck. My point is that there is nothing that precludes a local Enforcement Authority from going after a wrongdoer and securing a fine and using it for whatever purpose they choose, even if Section 8(b) were operative law.

Ms. Schapiro, do you have any different view?

Ms. SCHAPIRO. No, I do not.

Mr. MANZULLO. Will you yield, Mr. Chairman?

Chairman BAKER. Sure. I would be happy to yield to the gentleman.

Mr. MANZULLO. Let me construct something.

Chairman BAKER. This is Mr. Tiberi's time. He is yielding to you.

Mr. MANZULLO. All right. The example the chairman gave, they go after Corporation X; they recover $100 million, but that $100 million was ill-gotten gains by that particular broker or corporation as a result of setting up fraudulent operations against senior citizens.

Rather than totally removing the brokering operation or the corporation from doing business in the future, the Attorney General secures as part of the settlement the agreement of on-spot monitoring of everyone dealing with that corporation or broker over the age of 65 because it is making the assumption is was some sort of fraud on senior citizens. That would change the structure. That would be outside the normal penalty that the Federal government SEC could lay in. That would trigger the funds under section 8(b) going to the Federal government, as opposed to coming to the State.

So the question that comes to my mind, is the Attorney General that was pursuing that, would he probably study the structure of the settlement so as not to change the structure of security laws, so that the receipts would come back to the State, even though the proper methodology if you are handling that was perhaps setting up a monitoring device to protect 65-year-olds or older who were being particularly defrauded by this scheme?

Chairman BAKER. Reclaiming Mr. Tiberi's time, the structure the gentleman suggests would not change Federal market structure. It would have to be something inconsistent with current Federal regulatory oversight that would trigger this provision. So I appreciate the gentleman's point, but it is a very narrow field of applicability that triggers this response.

Mr. Cutler may want to respond or may not. Mr. Cutler?

Mr. CUTLER. Again, to the extent that it does not change the national market regulations that we have in place, it obviously would not trigger the provision.

Chairman BAKER. Define that. It would be helpful to us to define "Federal market regulations in place." What does that reference?

Mr. CUTLER. As I understand it from the legislation, it is rules and requirements at the SEC level, as well as the SRO level, that are currently in effect.

Chairman BAKER. So in effect, the State could not change SEC rules and regulations unilaterally, or if they did and fined, then the money would come to us.

Mr. CUTLER. That is my understanding.

Mr. KANJORSKI. May I add to that question, though? Under current SEC regulations, do you have the authority to establish monitoring of a particular category of brokers or corporations in dealing with 65-year-olds? Do you have that? I am not aware that you would have the ability to do that.

Ms. SCHAPIRO. If I might jump in, I believe under SRO rules it would not be violating an SRO rule or an SEC rule or do any injustice here to say that as a result of a heightened supervision that is required under our rules with respect to particular conduct that takes place within a broker-dealer firm, that a firm must do anything necessary to guard against that conduct in the future, and could certainly, because the rules are written rather broadly, encompass something like maintaining separate records of how senior citizens are dealt with.

Mr. KANJORSKI. Ms. Schapiro, using that argument, there is practically nothing that could be required in a settlement that would trigger the funds under Section 8(b) to come to the Federal government.

Ms. SCHAPIRO. No, what I am suggesting is that in the example you posit, there is nothing that is contrary to self-regulatory organization rules that would in fact trigger this provision.

Mr. KANJORSKI. Okay. That is for your rules. How about the SEC?

Ms. SCHAPIRO. It is either rules, as I understand it.

Mr. KANJORSKI. Well, is there anything in the settlement, then, that could trigger and would be in violation of those rules? I am not sure. I mean, you are seeming to say that a settlement could call for any structure and that would not be in violation of your rules or the SEC rules. If that is the case, then there will be no triggering mechanism for Section 8(b) to apply where the funds would come to the Federal government.

Ms. SCHAPIRO. No, I do not believe that is the case. I think if you look at, for example, the Global settlement, which required fundamental structural changes in an investment bank, that that is the kind of thing that would probably trigger this requirement. I do believe there will be some interpretive issues around exactly what falls under this provision and what does not, and what is contrary to an existing SEC or SRO rule.

Mr. KANJORSKI. Who is the final determiner of whether they make a structural change like that? The Federal SEC? The Attorney General of the State? The Justice Department of the United States? Who makes that determination?

Ms. SCHAPIRO. I think that is one of the issues that probably needs some further discussion.

Chairman BAKER. Mr. Kanjorski, you have exhausted Mr. Tiberi's time.

Mr. TIBERI. Mr. Chairman, that is the most time I have ever had.

[LAUGHTER]

Chairman BAKER. And it is the most effective use you have ever made.

[LAUGHTER]

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman.

I wish to address my first question to Ms. Schapiro. How do you think Section 8(b) of this legislation will affect a State's ability to robustly combat corporate fraud?

Ms. SCHAPIRO. Thank you. I really would associate myself with Mr. Cutler's remarks. I think that there should not be any disincentive to rigorous State enforcement of the laws. My experience in working with State regulators over many, many years as an SEC commissioner, a chairman of another Federal agency, and at the NASD has been that they are as committed and dedicated to investor protection, regardless of where fine money or other remedy funds go. I think that they will maintain that commitment regardless.

I also think that this really is a fairly circumscribed provision that does not hurt their ability to get fines so long as there is not prescriptive relief that changes either SRO or SEC rules. Of course, where they believe that that is the right remedy to change SRO or SEC rules in how a broker-dealer operates, then there would not be fine money, but one would hope that the Federal regulators would also step in there and more broadly look at that conduct.

I think over time, we have to look at the impact of any legislation to see if any kinds of disincentives are created. But I think the combination of the professionalism of State Securities Administrators and their commitment to investor protection, and the narrowness of this bill, really should not create any disincentive.

Mr. HINOJOSA. Mr. Cutler, some time ago SEC gave our committee some suggestions on how to improve investor protection in our marketplace. Why did you not see a need for these reforms back in February?

Mr. CUTLER. Mr. Hinojosa, are you talking about Section 8(b) in particular?

Mr. HINOJOSA. Well, the new amendments that are being proposed now to strengthen the law that we have is one that I think you should have brought to us back when you came and spoke in

February, I believe, and that is specifically Section 8(b) that we are discussing today.

Mr. CUTLER. Right. I think what has spotlighted, if you will, the Section 8(b) concern is the Global Research Analyst settlement which we had not yet consummated back in February. I think what has given rise to the concern about the use of penalty monies is the way that we are dealing with the Global Research Analyst settlement and the proposed distribution of monies in that settlement. That has only happened recently.

Mr. HINOJOSA. With that, Mr. Chairman, I yield back my time.

Excuse me, I would like to give my time, then, to Mr. Emanuel.

Mr. EMANUEL. Could you expound? Earlier you had said something about monies being fungible as we were dealing with the homestead, to go back to that. I think you were onto something and then you kind of veered off or got cut off. So can you expound on what you were talking about as it related to money being fungible and its relationship to the homestead issue?

Mr. CUTLER. Sure. The concern is that if illicit monies, monies wrongfully obtained are, let's say, put in the bank, and then monies from the liquidation of stock were used to buy a house, under a provision which limited our ability to go after a homestead to where we could actually trace the money to the homestead, the homestead in that example might be protected because the monies were literally used for something other than the purchase of the house.

Mr. EMANUEL. Do you have a particular example or cases where in fact exactly what you were trying to get at, because what I am trying to do is find a way to address some of the questions my colleagues have asked, both from Illinois and Florida, in the sense that one does not want to see the SEC stopped, but on the other hand where somebody is clearly using cracks within the law, fissures in the law to hide monies and dollars, that I want to address. So if there is a way that we can kind of lock these two together in some area. Do you have specific cases that come to mind or are there cases that exist where people clearly were buying a house for that purpose of sheltering dollars that would normally go back to those who have been defrauded?

Mr. CUTLER. I cannot summon any right here. We will go back and look at it. The concern I would have, Mr. Emanuel, is that because of the way current law operates, there may be no need for a criminal or wrongdoer under the civil securities laws to go ahead and engage in that kind of mechanism. That is, that there would be no need to do anything other than plop the money right into the house. But we will go back and look, and I think your inclination is exactly right and you are a terrific diplomat.

Mr. EMANUEL. That also has never been used to describe me.

[LAUGHTER]

Chairman BAKER. And the gentleman's time has expired as well.

Mr. EMANUEL. Thank you. I have made the most use of my time today. Thank you.

Chairman BAKER. Very helpful, sir.

I need to correct the record. In response to Mr. Manzullo's question relative to homestead exemption in bankruptcy proceedings, I had indicated my recollection of Sarbanes-Oxley was that there was bankruptcy court protection against a securities fraud penalty being assessed. Section 803, staff has informed me, which was in the final adopted version of Sarbanes-Oxley, disallows, and this is significant, discharge under bankruptcy of any debt arising under a securities law claim, meaning if the person has engaged in wrongful conduct and has been fined by the SEC, that is not protected in bankruptcy proceedings. So the concerns raised by Mr. Manzullo should have been raised with regard to Sarbanes-Oxley as well, because you now have a privileged position as a result of the passage of that Act. So we may talk about both issues in the same context.

Ms. Biggert?

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman.

I find myself as a member from the New York delegation in an interesting position here, because I do not necessarily disagree with where you are going, but I am at the same time somewhat defending my Attorney General for what was really some outstanding work in the settlement in my State. Let me first say that in New York, we know that the industry in which Mr. Spitzer was engaged in investigating is an important one for New York State and for New York City. It is critical. It is crucial. I do know it goes beyond New York. The market and the marketplace is something that this nation and the world is concerned about.

But I think besides our Federal banking laws, there are probably only two other banking laws in the world that really matter. One is Switzerland's and the other is New York State's banking laws. The Martin Act is the State law which Attorney General Spitzer used to conduct his investigation.

Also, I consider all the money from the people who pay taxes in New York were spent on the investigation. So it is not really unreasonable for me to see at the end when there is a settlement that New York State would look to recoup some of the monies that were spent in that investigation, and one that was brought to a conclusion that amounts to some $1.5 billion. So just for the record, I want to state that.

One side says yes, well, there should be uniformity, and I think you are saying that Mr. Spitzer agrees with you, Mr. Cutler, that there should be some form of uniformity. I am one who generally supports preemption on many of these issues from the Federal end. But here is an example where New York State took the bull by the horns, that may not be the right animal to describe here, but he certainly did in this case, and I think deserves a great deal of credit for the settlement that took place.

I also think it is hard to separate whether or not that would not have an impact upon Mr. Spitzer or whoever he or she may be, the Attorney General of New York State or any State. It is really difficult for me to believe that that is not going to have an impact on their ability to conduct those investigations. I do not know what the cost of the investigation was. It probably was not $50 million. I do not know what it was, but it was a considerable amount of money. I just wanted to lay that out there.

I have a question, though, in regards to some of the discussion that I have heard trickle down to my office from Wall Street and their lawyers is that it is believed by many that a considerable portion of the penalties that some of these firms have been hit with, they believe can be paid by insurance companies that they have contracted out with. What is your feeling on that? Do you think that that is fair if that is the case? And is that true and is that fair? It is almost like the analogy of if I got a ticket for speeding on the New York State Thruway, I would ask my insurance company to pay for it. Innately, that does not seem very fair to me. Can you comment on that?

Mr. CUTLER. Sure. I agree with you. What we did in the Research Analyst settlement is something we had never done before, which was to include a provision which expressly prohibits any of the firms from seeking insurance coverage or indemnification for the penalty portion of their payments.

Mr. CROWLEY. So it is covered in that? You have come to an agreement that is solid on this, right?

Mr. CUTLER. Yes.

Mr. CROWLEY. Okay. I appreciate it, and thank you very much. I yield back the balance of my time.

Chairman BAKER. Thank you, Mr. Crowley.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman.

Mr. Cutler and Ms. Schapiro, thank you very much for appearing here today. I believe that the legislation does have merits and I have a couple of questions that I would like to ask.

My first question deals with Section 8(d) of the bill. This section provides that SEC may use undistributed amounts of fund from disgorgement funds or FAIR funds to educate investors. Such educational programs would be administered by an established not-for-profit or governmental organization. I commend these efforts. I agree that financial literacy is crucial for participation in capital markets. Financial literacy is the first line of defense against fraud.

Could you tell me what kind of programs you have in mind? That is question number one. Number two: What kind of organizations would administer these programs? That is question number two. And are you making efforts to target Hispanics and other minorities?

Ms. SCHAPIRO. Under the legislation, any undistributed funds could be used for investor education. That would include funds where it was just infeasible to distribute the money or where there was more money than was appropriate to distribute. The money could be administered for investor education purposes by a not-for-profit foundation and so forth, or a governmental entity. It will obviously be the SEC's choice ultimately about what to do in that regard.

I will say that there is an enormous amount of money as well available under the Global settlement for investor education purposes that will be administered through a court-approved plan to broadly educate investors about how to make better decisions with respect to the stock market and other investing. As part of that, I would hope and we have encouraged the SEC to do a survey of what works and what doesn't work in the investor education arena.

There are hundreds of organizations engaged in investor education. There are wonderful programs that develop high school curricula, that target the Hispanic community, senior citizens, the African American community. All of those are areas where we need to put a renewed emphasis on investor education. It is part of what NASD is doing.

Now, I would turn it over to Steve for the specifics.

Mr. CUTLER. Mr. Baca, I think it is critical that any investor outreach and education efforts embrace all sectors of society. We ought to, and I think it is incumbent upon the government to embrace the concept of diversity when it comes to investor education dollars. I agree with my colleague in that regard.

Mr. BACA. Thank you very much. That is why I hope that we look at the kind of programs that we develop to target not only the Hispanic population, but other minorities as well. But what kind of programs would administer these? I don't know. Do you have a list or something that would be available for us that would administer these kinds of programs?

Mr. CUTLER. We can certainly get to you a list of current investor education programs and entities. I know that in connection with the Global Research Analyst settlement, it is something that we are looking at very hard because we have available in connection with that settlement on the Federal side on the order of $50 million over a five-year period to expend on investor education efforts. Our investor education office is gathering a list, I assume they actually already have it, and we will provide it to you, of investor education programs that currently exist.

Mr. BACA. Okay. Thank you.

My second question is in regard to Section 7 of the bill. Section 7 authorizes SEC to retain private legal counsel to collect debt owed as a result of SEC judgments or orders and to negotiate appropriate fees to pay for such private legal counsel. As I understand it, this provision would enhance the SEC's ability to recover more of the money owed by securities law violators.

How does this program compare to efforts by other agencies to hire private sector debt collection contractors? That is question number one. And then question number two, is this different than the program run by the IRS in which contractors violate the Fair Debt Collection Practice Act, which is question two. And three is, are these just apples and oranges, is there some level of commonality that should concern me?

Mr. CUTLER. We do think this provision would be very helpful. It is a power that I believe the Department of Justice already has available to it, to contract directly with private Attorneys. We have not had that power. It has created a number of inefficiencies in how we go about collecting on judgments.

We also think it would allow us to leverage our resources much more effectively because the collection of judgments invariably turns on interpretations of State law. It is a lot more efficient to be able to rely on local counsel in the relevant jurisdiction than to have a Federal regulator learn the collection procedures and laws of each jurisdiction around the country.

What makes some of our judgments different than other judgments is that they tend to be big, and they also tend to have been collected from scofflaws or entered against scofflaws, and that differs from other sorts of judgments that other government agencies would ordinarily try to collect.

I understand your concern about violations of the Federal Debt Collection Act, and I think it would be incumbent upon us in the contracting process with private law firms to ensure that we have protections in place so that those violations do not occur.

Mr. BACA. Could there be a possibility of double-dipping in collecting by one agency versus another?

Chairman BAKER. That will be the gentleman's last question. Your time has expired, but please respond.

Mr. CUTLER. That does not strike me as a particular problem, and I think we could work that out.

Chairman BAKER. Thank you, Mr. Baca.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman.

I think I caught the tail end of Joe Crowley, the gentleman from New York's statement. I am also from New York and have a background somewhat. I used to be an investigator for the New York State Investigation Commission. On the whole question about restitution, no one wants to say they are against restitution to individuals who have been defrauded.

However, on the question of how much money we are talking about and how many people are in the class, so how much really do they get back, I think that is a real question, as opposed to the costs to undergo the investigation, et cetera, as the States have done. That is a real consideration and something that I think we have to look at and make a determination on because we do not want to dissuade the States's Attorneys general, whether it is New York's or anyone else, from engaging in investigations because they know the cost of it and they cannot recoup any of those costs. So that is a real concern.

Let me ask this to you, Mr. Cutler. I really want to ask you a question that is more related to a hearing that we conducted Tuesday regarding employee stock options. I understand that the offer of employee stock options helps small cash-strapped companies attract top-rate employees in place of a salary. Actually, I support that.

On the other hand, I am tremendously concerned when I look at companies like WorldCom, whose executives manipulated their own stocks and statements to boost the stock price, and turned the benefit of their own stock to their benefit. And then I know that we go after individuals, and I am not talking about anything but the merit of the case, et cetera, when you are talking about what is happening with Martha Stewart, but when we look at what is being done with the settlement now of $1.5 billion, which WorldCom was going to have to pay, I guess the agreement is now $500 million.

The question that I have is, with all of this, and I do not see anybody from any of the executives being indicted right now from WorldCom. Let me ask you the question I asked on Tuesday. How do we maintain stock options as an incentive for hard work, while not providing an incentive for executive management to manipulate their own compensation? Do you have any opinion on that?

Mr. CUTLER. Discretion suggests to me that I do not. I am just the enforcement thug who when they tell me what the law is, I go out and prosecute violations of it. I think probably the policy questions here are better left to others. I know certainly it has been a problem in the past, executive compensation and whether that creates the right incentives. But I cannot give you advice on how to get out of that box. I know that the expensing of options is now an issue before FASB.

Mr. MEEKS. Ms. Schapiro?

Ms. SCHAPIRO. I guess I should exercise the same discretion as Mr. Cutler and not answer. But I will say that I think options have served an important purpose for many companies over the past 10 or so years in this country. I think the problem is abuses, grants of stock options.

I think much has happened under Sarbanes-Oxley and other events in the last year that really have given management compensation committees of boards of directors a higher sense of what their obligation is to shareholders when they are granting stock options. I believe that we are starting to see a chilling effect of some of the events in the last year on abuse of grants of stock options.

The other terribly important thing here is the appropriate accounting treatment for stock options. That will do more, I think, than any other thing to cut down on abuse of grants of stock options, if they are accounted for correctly.

Mr. MEEKS. Thank you.

Mr. CROWLEY. Will the gentleman yield?

Mr. MEEKS. I yield.

Mr. CROWLEY. Thank you. I thank my colleague for yielding.

I just wanted to go back real quickly. I had my staff just check something out before I brought it up. I understand that in the settlement that took place, that all the companies involved admitted to no wrongdoing and that was part of the settlement. I am not suggesting anything beyond that.

I just wanted to go to another set of laws and rules, the RICO laws. I am not suggesting, again, that these companies were involved in any type of action that could be undertaken by RICO. But under those set of laws, isn't it true that local law enforcement is able to retain a portion of the ill-gotten gains and possibly sell them off and use the proceeds to fight crime in their jurisdictions? If that is the case, aren't we setting up a separate protocol in the future for illegal-gotten gains within the financial services and the capital markets sector specifically?

Mr. CUTLER. I cannot tell you because I am not an expert on RICO. I can tell you, Mr. Crowley, that I do not think the issue of recouping expenses was the turning point, if you will, for the fulcrum of the decision by the New York Attorney General and others about where the money should go. Indeed, back in December when we announced the settlement in principle, I know that Mr. Spitzer said at that time that to the extent practicable, any monies that the State of New York collected would be returned to investors.

Now, at the end of the day for statutory and other reasons, the New York Attorney General determined that it was not practicable, but it was not an issue, and he can speak to this, and I think Ms.

Bruenn can speak to this as well, it was not an issue about whether to recoup expenses or not.

Mr. CROWLEY. I agree with you. I don't mean to say that that was the sole purpose. That wasn't. At the same time, New York is not asking for one-third of the money that was recouped either, and putting that into the New York State coffers as well. So I mean, all things said and done, $50 million is a very small amount in the overall picture of the $1.5 billion.

I thank you for your time and I thank the chairman for the time.

Chairman BAKER. Thank you, Mr. Crowley.

I would just observe that much of what is contained in Section 8(b) is responsive to comments by many States's Attorneys general who said, one, we may not have the authority, but two, we clearly do not have the resources, although we agree that restitution should be a principal goal. I think we are very close to having resolution to the matter that the committee would find favorable.

Certainly, we can address expenses of litigation as an appropriate cost item to be shared by the State, but one overriding element that we cannot take our eye off of, the money came from somebody's pocket. It is no different from walking down the street and seeing someone drop a $20 bill and making the effort to pick it up and give it back to them. I think that is an extremely important role for the government to pursue, and I think we can achieve that goal ultimately.

I am going to suggest a recess, given the pending vote on the floor, unless any member has any further statement or question of this panel.

Mr. CROWLEY. If the gentleman could just yield for a moment.

I don't disagree with your premise either. I think it is difficult for those people who have been wronged to have the advocacy outside the SEC, and the SEC does a wonderful job and are not paid enough to do the job that they do. Having said that, in New York State, for instance, the Attorney General's office, he is acting on behalf of his constituency, which is within New York State, many of whom have been wronged. So I do understand that. I do not necessarily disagree with the premise of our panelists either, that there should be some uniformity and conformity, and I am happy to hear that you are open to discussing how that can be divided in the future.

Chairman BAKER. Sure. No, I laud him for grabbing the horns of the bull. The only question I have is where he sent the filets. That is all I am talking about.

[LAUGHTER]

Let me express my appreciation to the panel for their helpful testimony this morning. We are going to stand in recess for a few minutes. We have more than one vote. We will return as soon as possible to reconvene for our second panel.

Thank you.

Mr. CUTLER. Thank you.

[RECESS]

Chairman BAKER. We are going to go ahead and proceed. It would be inappropriate to keep you waiting without presenting your testimony. In fairness to the hearing record, what I would then do is probably submit my questions in writing, since there is no member from the other side to have equal time. That is acceptable to me, and I think to the folks representing both interests.

So at this time, Ms. Christine Bruenn, President, North American Securities Administrators Association. Welcome. Your full testimony will certainly be made part of the record. In the meantime if we get a second member, we will stay around for a bit.

Please proceed.

STATEMENT OF CHRISTINE A. BRUENN, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Ms. BRUENN. Thank you, Chairman Baker.

I am Christine Bruenn, Maine Securities Administrator and President of the North American Securities Administrators Association. I commend you for holding this hearing and thank you for the opportunity to appear before your committee to present the States' views on the Securities Fraud Deterrence and Investor Restitution Act of 2003.

The Securities Administrators in your States are responsible for the licensing of firms and investment professionals, the registration of some securities offerings, branch officer, sales practice audits, investor education, and most importantly the enforcement of State securities laws.

Some securities commissioners are appointed by their Governors or Secretaries of State. Others are career State government employees. Notably, only five report to or are under the jurisdiction of their Attorneys general. We have been called the local cops on the securities beat, and I believe that is an accurate characterization. Because of our proximity to the local investor, the States are an indispensable early warning system for fraud. The State Securities Regulators work with national regulators on market-wide solutions.

That was the pattern followed with penny stock fraud, micro-cap fraud, day trading, and other areas. It bears repeating: The States investigate and bring enforcement actions; they do not engage in rulemaking for the national markets. That is rightly the purview of the SEC and the SROs.

We appreciate the subcommittee's leadership in identifying some of the practices that resulted in the analyst conflicts of interest inquiry, as well as the continuation of the work you started during the last Congress that culminated in the Sarbanes-Oxley Act. NASAA applauds the subcommittee for many of the provisions in H.R. 2179. We appreciate your commitment to strengthening securities regulation and we want to work with you to reach our shared goals of enhanced investor protection and stiffer penalties for those who commit securities fraud. Given what has happened in the past few years on Wall Street and in boardrooms across the country, now is the time to strengthen, not weaken, investor protection.

Although NASAA supports the vast majority of the provisions in H.R. 2179, I must express our deep concerns regarding Section 8(b). First let me say that we share your goal of returning more funds to defrauded investors. We agree that restitution should be a priority for all regulators. In fact, a primary and routine objective of State Securities Regulators is to obtain restitution for investors as part of enforcement actions. For example, in the 2002 reporting period, State Securities Regulators collectively obtained orders of over $309 million in restitution. During the same period, roughly only $71 million was ordered in fines and penalties.

To make the point that restitution is a priority, let me illustrate with some statistics. In my home State of Maine for fiscal year 2003 to date, my agency participated in the return of over $2.8 million to investor victims, while collecting, apart from the Merrill Lynch settlement, only $16,000 in penalties to the general fund. Data for Pennsylvania reflects the same priorities. For fiscal year 2003 to date, the Pennsylvania Securities Commission oversaw the payment of $8.2 million in restitution and disgorgement and the collection of just $130,057 in civil penalties.

While we agree on the priority of restitution, there are provisions of H.R. 2179 that raise practical and public policy issues, as well as the specter of unintended consequences that could actually harm investors. We believe it would be bad public policy to attempt to direct a State authority to remit a civil penalty or disgorgement ordered in a State case to a Federal governmental body for distribution. These funds rightfully belong to the citizens or investors in the State. Decisions regarding the use of penalties are best made by the State legislatures and regulators so they can be tailored to the unique circumstances of each jurisdiction.

State Securities Regulators apply a variety of sanctions when taking enforcement actions against broker-dealers, depending upon the specific facts of each case. Remedial sanctions are very important enforcement tools in addition to restitution and monetary penalties. Where State Securities Regulators investigate and resolve enforcement cases using these remedies, their judgment regarding appropriate outcomes should be respected and supported. We impose remedies to suit the particular enforcement case and use our discretion to address unique situations.

There are a wide variety of remedies we may choose to impose. In the case of selling unsuitable investments, for instance, we may have the branch manager review trades and compare them with a customer's investment objectives, or ask a broker-dealer, for a fixed period of time, to keep a separate file on transactions with senior citizens. In other cases, closer supervision of a broker, expansion of the compliance department, or enhancement of internal controls might be necessary.

Finally, the legislation leaves open some questions. It is unclear if it would apply if a State imposed the same remedial sanctions that were imposed in a parallel Federal proceeding, where both the State and Federal orders went beyond the requirements of Federal law. The uncertainty in the mechanics of the bill points to another problem. When the State, the SEC and the industry respondent in a given case disagree on whether the provisions of Section 8(b) are triggered, how is that impasse to be resolved? This question suggests increased conflict between all three players and resources being wasted in resolving such disputes.

In contrast with this scenario is the very positive experience in the recent Global settlement with the leading Wall Street firms. In my view, the Global investigation and agreement was a model for State-Federal cooperation that will serve the best interests of investors nationwide. We must be able to leverage our resources and continue to work together on these cases. With 85 million investors relying on our securities markets to meet their financial goals, and on regulators to keep their markets well-policed, we cannot afford to undermine our complementary regulatory system.

To sum up our concerns, while we wholeheartedly support the provisions in H.R. 2179 to strengthen the SEC's Enforcement Authority, it appears to be inconsistent to enhance the SEC's enforcement power while at the same time inhibiting the States's options in enforcement actions.

Mr. Chairman and members of the subcommittee, in closing I want to repeat our support of the goals of this legislation. The SEC needs more authority and resources, and those who break our securities laws should pay a higher price than they do today. But we are deeply troubled that this legislation, while strengthening the SEC, could weaken and limit the efforts of State Securities Regulators to protect investors in your States. Eighty-five million investors, many of them wary and cynical, expect us to remain vigilant, to work together, to stay the course, and to make sure that Wall Street puts investors first.

I pledge the support of the NASAA membership to work with you and your subcommittee. We would be willing to work with the SEC and others to come to an agreement on Section 8(b) and to provide you with any additional information and any assistance you may need.

Thank you for this opportunity to testify.

[The prepared statement of Christine A. Bruenn can be found on page 52 in the appendix.]

Chairman BAKER. Thank you, Ms. Bruenn.

I noted on page four of your testimony when you were referencing the actions in Maine, Pennsylvania and Arizona, and the collections made in reference to the penalties assessed. To your knowledge, particularly in the State of Maine where I am certain you do know, were those penalties or recoupments in relation to events or activities that were within your State and affected principally residents of the State of Maine?

Ms. BRUENN. The way I would respond to that is to say that those investigations primarily affected Maine investors. There are occasions when our cases go into New Hampshire or Massachusetts, or we collectively join with other regulators in either New England or nationwide on a particular broker-dealer or a particular issue.

I think the important point here is that I have made it a priority to take penalties generally unless I have made restitution first. I absolutely agree that restitution should be the priority in every example. I think we have had a difference on one case, the Analyst case, about what the right answer is, but I totally agree with you that restitution should always be a priority.

Chairman BAKER. Thank you for that. The point of my question was that generally speaking the actions taken in the three States that generated the restitution cited in relation to the small amount of penalty were more often than not local aberrations within the State over which you have jurisdiction. You would not, for example, tell the people of Pennsylvania with your actions what remedy they should seek with regard to misconduct in securities markets.

Ms. BRUENN. I can speak for Maine. Our penalties are generally for brokerage firms who have violated a specific statute in Maine, with Maine investors.

Chairman BAKER. That being the point, there are a couple of observations. One, generally speaking these were local in nature in violation of a particular statute or regulation of the agency. Secondly, it is responsive to the point made earlier, if you do not get to keep the money, would you take the action?

You have three States where you have had significant recoupment and very small penalties in relation to that action, only $16,000 in monies to the general fund, and giving $2.8 million in compensation to Maine residents. That is a pretty good deal. I think it supports the view by Mr. Cutler earlier in the day that professional regulatory agents are going to act in the best interest of their constituents, money notwithstanding.

Secondly, under Section 8(b) as constructed, if you took the actions cited in these three States and laid them aside the requirements of Section 8(b), and it may not be appropriate to do it today, but I would like to get back from you the case, just take Maine, we will keep it narrow, and present to us the prohibitions that the resolutions reached would not have been permissible under Section 8(b). That would be very helpful to us.

It is not the intent to preclude State regulators from acting, but it is the intent to make sure that where your actions go beyond State boundaries, where there are people who have been wronged, and where you take the money and bring it into your State general fund, and it is not distributed to those non-resident victims, there ought to be a way to work this out.

If you can give us case-specific points that show how the proposed rule is not consistent with the remedy you have sought in those $2.8 million worth of recoupment in Maine, that would be very instructive, because we have limited the taking of the dollars to a twofold step. You have got to change market structure and you have got to seek a penalty.

Now, I would be happy to look at even stipulating further, as we have had these discussions with the Consumer Federation, where it clearly is an action relating, for example, to a broker-dealer in a city who has run false advertisements and you find him, there is no question about that. That stays with a State. There ought to be a way to have an illustrative list and then figure out how we describe it.

Let me put it this way. Do you have a theoretical problem, forgetting Section 8(b), with giving money back to people who have been defrauded, when your actions within your State make resources available, and the preponderance of investors who would benefit from your action are not within your State?

Ms. BRUENN. Mr. Chairman, I think you have identified the key issue here, which is the triggering mechanism. I think the way we were reading Section 8(b), the trigger seemed much broader than the way it has been described here today. I believe that we could probably work together on coming up with something that made us all comfortable. I need to be free to do my routine investigations that affect one broker or eight brokers and 25 or 50 or 150 investors in Maine, where I can impose a remedy that seems to address a particular broker-dealer or branch office's problem in that case.

My jurisdiction is very narrow. It is for offers and sales of securities in Maine. I do not have the authority to tell any broker-dealer how to do their business outside my boundaries. So I feel very comfortable saying to you that I think that there is an answer here.

Chairman BAKER. Let me return to the question, because I want to make sure we get on the record a specific answer, and we can take the Global settlement as the nexus to come together here. There is no evidence that 50 percent of the harmed investors as a result of the Merrill Lynch settlement resided in New York, yet half the money went to New York. That was the problematic aspect of the settlement from my perspective.

Secondly, only a very small portion of the Global settlement, again from my perspective, went to investor restitution. From Maine looking into the Global settlement, if 20 percent of the investors lived in Maine, I would have no difficulty in supporting an effort to give Maine 20 percent of the settlement. Would you object to that?

Ms. BRUENN. No, sir. And we tried to address exactly the concern you raise. I think, one, the Merrill Lynch settlement was a unique circumstance where the State of New York's Attorney General had already done most of the work, and was trying to make sure that the procedure ended with all of the States coming together. I think it was a very unique situation, and I would hate for all of State securities regulation and our approach to restitution to be judged by that one case.

Chairman BAKER. No, we are together. All I am suggesting is if you take an action that results in harmed investors outside your State not having the opportunity for restitution, but it is your prompt corrective action that brought this person to justice, you would not object to a mechanism to provide for distribution of compensation to people outside the State, as long as you do not have to do it yourself. You do not have to pay for it and you do not have to sort out who gets what.

That is the reason for the SEC distribution mechanism, because every State Attorney General who has come to us expressing concern said, "We don't have the ability to do this." I said, well, would you object to the SEC doing it? "Well, no, as long as we got fair treatment."

Ms. BRUENN. I guess the problem I have is that with that particular Merrill Lynch settlement, for instance, Maine got 1 percent of the penalty money. So putting aside what New York got and whether that was the right way to do it or not, the rest of the States divided up the money based on population, trying to address the fact that in a small State I am going to have fewer victims than they are going to have in a much larger State. I think we tried to do that. I think my problem with the legislation is it takes away my discretion.

Chairman BAKER. Let me jump on that small State issue.

Ms. BRUENN. Okay.

Chairman BAKER. If Connecticut, a high-income State, sophisticated people, contrast that with Louisiana. I will guarantee you, there are five times as many investors harmed by the Merrill

Lynch action as there were in Louisiana. Now, why should we get more money than Connecticut because we have a bigger population?

The equity of it is what I am driving at. That is the whole issue behind the proposal, is if we are going to collect vast sums of money, we ought to make sure we make our best effort, and if there are legitimate reasons why we cannot, let's explain it. But let's make our best effort to give the money back to the people from whom it was taken.

I am going to yield to Mr. Kanjorski.

Mr. KANJORSKI. Mr. Cutler does not believe that there would be any budgetary considerations by State regulators or Attorneys general in expending money for lawsuits where there would be a small recovery. Do you feel that, at least in some way, the States that get heavily involved in these transactions and expend a larger portion of their budget or allocation for that particular litigation, should be compensated for that, as opposed to just splitting it in some formula without taking that into consideration? If you don't take that into consideration, will that tend to cause the justice departments of the various States or the SECs of the various States not to be as aggressive?

Ms. BRUENN. Representative Kanjorski, I believe we are all committed public servants and we are going to go do the right thing whether the funding comes our way or not. However, we are also human, and we run agencies where we are expected to produce results. If the results are that money gets sent to Washington, with all due respect, I have to say that that will undermine my ability to get funding for my agency.

Mr. KANJORSKI. Do any of these actions constitute something similar, or are they constructed in the class action type of situation where the decision process would eliminate any further liability if other actions are brought by other individuals?

Ms. BRUENN. Under the State laws, investors in our States are not only served by the actions that I bring as a regulator and my colleagues bring as regulators, but they have their own private cause of action that can be pursued either in a class action lawsuit or in arbitration. We had three goals in the Analyst conflicts of interest settlement. One of them was to make sure that we provided information for investors. We intend to help them with that arbitration process.

Mr. KANJORSKI. So the courts do not consolidate the actions into one class action? They preserve the rights of private class actions or private investor lawsuits? Is that correct?

Ms. BRUENN. I am not an expert on class action law, but I would point out that most of these actions will be brought in arbitrations which are not consolidated. Each investor gets the opportunity to have a hearing based on their own personal situation.

Mr. KANJORSKI. That is in making restitution claims from the State of Maine. I am talking about in the recovery from the party who has wronged them. What I am trying to get at, is there any time, as in class actions, that a settlement constitutes a universal global settlement, and that forestalls any other State or any other class from bringing any action against that particular defendant, and the potentiality of that being abused?

I do not want to suggest it, but in corporation law, we have seen that Delaware has created a mechanism to become the land of corporations. You theoretically could have another State, Louisiana, become the land of securities transactions in order to allow a final settlement to be arrived at to bar any further recovery from other States that probably suffered a great deal more. I don't want to suggest that they would act as a straw man or a shill for the defendants, but in fact they could do that.

Ms. BRUENN. To the best of my knowledge, there is no State jurisdiction that would preclude any other regulator from also bringing an action, or any individual from pursuing their private right of action. No settlement would preclude another action.

Mr. KANJORSKI. So what happens is they insist before they arrive at a settlement that all 50 States's Securities Regulators enter into the agreement and are satisfied with the disposition of the funds?

Ms. BRUENN. That happens in these very large cases with national impact. The defendants want to make sure that the States will have buy-in, and that is where we have used the mechanism of NASAA, the membership organization that I am serving as President, to bring the States together and to try and speak with one voice and come up with one resolution.

Mr. KANJORSKI. Do you think the bill as presently structured fails to put in place a mechanism to decide how the disposition should be made or whether there is a change in the structural laws or regulations of securities so that it would trigger the mechanism to go to the Federal government? Do we have to find some arbiter, rather than retreating to a full class and Supreme Court decision between the SEC and the various States, which could be very expensive and probably smaller States would not be able to be parties to it just because of the expense involved?

Do you see a need for some final decision making body that is representative of the interests of both the States and the Federal government, a board of arbitration or something that would be set up and properly appointed to have a balanced representation to make some of these jurisdictional decisions as to whether or not the fines and disgorgements or other restitution would flow to the Federal government or the individual States?

Ms. BRUENN. I think we need a bill that is clear about the triggering mechanism. I would hope that we would have something that would be clear enough. I do not think it would be a good use of resources for me to be litigating with the SEC or with an industry member about what this bill means and whether I have overstepped my jurisdiction. I would like it to be as clear as possible.

We have had a very good relationship with the SEC. I think of us as being partners in working on the same issues, just from different perspectives. I think our relationship with them would be undermined if they became the big brother who got to go behind our cases.

I think the trigger here was the analyst cases. The New York Attorney General got out in front. I do not think you want to really preclude States from playing that role of being the early warning system on issues. I think what you want is a mechanism that says once that happens, let's all get together and resolve this together, with the SEC providing the national leadership.

Mr. KANJORSKI. From your statements just now, I suppose you don't mean to make the SEC, then, the final arbiter. We should have some independent entity to make that decision because there may be a time in the future that an SEC just asserts its jurisdiction all the time and makes the decision in favor of itself all the time. That would basically either give you the choice of going toward regular litigation or surrendering your rights eventually, and becoming cowed to the Federal SEC.

Ms. BRUENN. I would suggest that you are right; that if the SEC becomes the arbiter, our ability to be unique or initiate things that the SEC has not blessed would be hobbled.

Mr. KANJORSKI. Okay. You offered to participate with trying to work with the SEC and with the committee, to see if this can be crafted. Do you feel that Section 8(b) is something, and we know it all has merit, I mean, what the intentions are. I don't think anybody argues with the merit of the final result that we are trying to get at. But do you think we can craft something that is agreeable both to state regulators, to the SEC, and basically to the Congress to get the ideal accomplished?

Ms. BRUENN. I would hope so, and I am committed to trying.

Mr. KANJORSKI. Very good.

Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

I have a series of questions, and at this point I don't want to enter into and start a whole new series of questions. What I will do, just to give you notice, we will get a letter out to you probably tomorrow that will have a series of issues, for example, for illustrative purposes. I would like to see from your perspective what each State did allocate their settlement proceeds from the Global settlement to have on the record. So members who ask what happened to the money, and whether it is used for enforcement, for education, or for general fund purposes, can make that judgment. I know they will rely on your representations of what did take place as being the accurate indicator of how those funds were used.

I have other questions even with regard to NASAA's receipt of the $2 million allocation of the settlement and how that is utilized. So I will get that out.

I do appreciate the time you spent here today to testify before the committee, and I appreciate your good-faith representations to work with the committee to come to resolution. At least I think we are generally in accord, that getting money back to the people from whom it was taken is a good thing.

Mr. KANJORSKI. Mr. Chairman, may I call your attention to the fact that this administrator works for a great Governor, that was a former colleague of ours?

Chairman BAKER. Absolutely. I look forward to having further continued excellent cooperation as we move forward toward a legislative remedy to what we all agree is an appropriate step, and that is to give the money back to the people from whose pocket it was taken.

I thank you for your appearance here today.

Ms. BRUENN. Thank you for inviting me.

[Whereupon, at 12:42 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 5, 2003

Prepared, not delivered
Submitted for the Record

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit
"Fair Credit Reporting Act: How It Functions for Consumers and the Economy"

June 5, 2003

Thank you, Chairman Bachus, for convening this latest hearing of your Subcommittee on the vitally important subject of the Fair Credit Reporting Act.

The Subcommittee's hearing last month served to underscore the benefits to American consumers and the national economy of a credit reporting system that puts a premium on real-time information disclosure and ready access to credit. The testimony at that hearing left little doubt that congressional inaction on renewing the uniform national standards established by the 1996 amendments to the Fair Credit Reporting Act will have serious consequences, particularly in an economy where consumer spending now makes up over two-thirds of gross domestic product.

With mortgage interest rates at historic lows – and affordable consumer credit available to low and moderate-income consumers on a scale unthinkable only a decade ago – now is **not** the time for experimentation or for overturning well-settled legal standards governing the credit reporting and credit granting systems.

The Ranking Minority Member, Mr. Frank, and I are fully committed to a hearing process that is comprehensive, bipartisan, and informative for Members of the Committee, who will be called upon later this year to make legislative judgments on reauthorizing certain key provisions of the Fair Credit Reporting Act. This hearing, which will feature testimony from more than 20 government and private sector witnesses representing a broad range of philosophical and practical perspectives, is nothing if not comprehensive in its coverage. Importantly, it is also balanced – the Subcommittee will hear from witnesses who strongly believe that FCRA's uniform national standards must be extended; others who favor allowing those standards to expire so that the 50 States can impose different standards; and still others who fall somewhere in between.

Although it is somewhat outside the "regular order" to have four panels of witnesses testify at a subcommittee hearing, an exception has been made in this instance so that Members can receive what amounts to a "crash course" on the operation and effect of the national credit reporting system. Subsequent hearings scheduled for later this month will address other aspects of the Fair Credit Reporting Act, as well as related issues such as what more can and should be done to protect consumers from identity theft and from the potential misuse of their medical information. I am confident that by sometime later this summer, the Committee will have established a hearing record that can serve as the basis for legislating before the FCRA's uniform national standards expire at the end of this year. While many Members are quite properly reserving judgment on the underlying issues until the hearing process has run its course, it is my hope that the bipartisan spirit in which Chairman Bachus has initiated these hearings can result in a bipartisan Committee product at the end of the day.

Thank you again, Chairman Bachus, for all of your good work on this issue, and I look forward to the testimony of our witnesses.

STATEMENT OF REPRESENTATIVE WM LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003"

June 5, 2003

Good morning Chairman Baker, Ranking Member Kanjorski, Members of the committee and witnesses.

We are sorely in need of legislation that will strengthen the Securities and Exchange Commission's ability to prosecute wrongdoers, strengthen protections for investors, return monies to injured investors and strengthen market integrity.

In this climate of investor distrust of the markets, we must intensify the fight against fraud on all fronts. I am especially pleased that under the provisions of H.R. 2179, with judicial approval, the Justice Department will be able to share grand jury information with the SEC in more circumstances and at an earlier stage than is allowed under current statures. We must always be careful to protect rights of privacy. However, we must be able to recognize when some are using the cover of privacy to commit fraud. We must weed them out of the system. We can only do that by strengthening the tools that we give to our investigative and prosecutorial authorities.

I generally support most of the bill, but do have questions about some of the preemptions of state laws. I served in the State Legislature in Missouri for 17 years and have reservations about what the impact will be on the ability of states to investigate and bring those who practice fraud to Justice. States play a very important role in our securities markets. We do not want to compromise their ability to vigorously attack fraud and market misconduct. I think further study is needed before we take the step of having the states remit penalties obtained against brokers if the state stature that they were obtained differs from federal statures. If these changes do not improve investor restitution then we were too hasty.

I do agree that something must be done to eliminate the haven that some find in selected states homestead regulations. This haven must be eliminated, but is a blanket elimination of state homestead exemptions the answer? We will explore this and several other questions during this hearing and I eagerly anticipate them.

Mr. Chairman I ask unanimous consent to submit my statement to the record.

June 5, 2003

Opening Statement for Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing to consider HR 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003

Thank you, Mr. Chairman, for holding this important hearing and for your leadership, along with our full committee Chairman Oxley, on this issue.

Given the recent corporate corruption scandals that have plagued many of our largest publicly traded companies, costing their investors millions of dollars, the issue of full investor restitution must continue to be debated by this committee. Throughout my years in Congress, I have been a strong defender of shareholder's rights and am committed to seeing this issue addressed in a meaningful way.

Section 308(a) of the Sarbanes-Oxley Act of 2002 established the Fair Fund, which allows the Securities and Exchange Commission (SEC) to collect civil penalties in enforcement cases and add them to funds that benefit the victims of securities law violations. It also directed the SEC to submit a report to Congress, reviewing and analyzing its enforcement actions over the past five years to identify the procedures that would best ensure that monies are returned to defrauded investors. This February, our subcommittee received the SEC report and began our consideration of its findings.

Chairmen Oxley and Baker have introduced HR 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003 to address the reforms deemed necessary by the SEC. It contains several provisions designed to greatly increase the SEC's ability to levy and collect fines and disgorgement funds that can be made available for investor restitution. HR 2179 also addresses the identified state and federal procedures that impede the SEC's ability to perform these functions.

I look forward to a thorough debate of this legislation here today and encourage our witnesses to put forth any suggestions for improvement. Thank you again, Mr. Chairman, for calling us together this morning.

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ARMED SERVICES
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PROJECTION FORCES
TACTICAL AIR AND LAND FORCES

COMMITTEE ON
FINANCIAL SERVICES
SUBCOMMITTEES:
CAPITAL MARKETS, INSURANCE, AND
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Statement of Congressman Steve Israel
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
Hearing on H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003
June 5, 2003, 10:00 a.m.

Mister Chairman, thank you for introducing this legislation and bringing it before us today. I share your desire to improve the Securities and Exchange Commission's enforcement powers and look forward to working with you today and into the future on this very important issue.

This bill makes a number of relatively modest changes to the law. While modest, these changes are important and will improve the SEC's efficiency in pursuing fraud and getting restitution for investors. The victims of fraud do not want to hear about statutory limitations on SEC authority: they want results.

Some of these improved efficiencies include allowing the SEC to return penalty payments to investors, even if disgorgement has not been ordered. A small change, but in some cases it could mean the difference between an individual investor receiving funds or receiving empty promises. Another provision of this bill will allow the SEC to hire private collections firms to secure the money that someone owes as the result of an enforcement action. It will also make it harder for people to shield their assets after they have been found guilty of fraud. These are all important changes to how the SEC enforces the law.

While I strongly support most of this bill, I have some concerns regarding Section 8. The way I read this section, the bill would require that in a case where a state comes to a settlement with a broker-dealer on an issue that the SEC could also pursue, any funds secured in that settlement would have to be deposited into the SEC restitution fund.

While I strongly support the idea of restitution for investors, I also recognize how important our attorneys general have been in holding people accountable. My own state's attorney general, Eliot Spitzer, has been the leading figure in the response to a number of scandals. He took on the analyst issue while the federal government dragged its feet. And he got real results.

I fear, Mr. Chairman, that this section of the bill is targeted specifically at the efforts of Attorney General Spitzer. In fact, I fear that this section is designed to *discourage* state attorneys general from taking up issues like this in the future. If this is the case, it would be a terrible mistake.

Our attorneys general have an incredibly important role to play in ensuring that individual investors and working people are treated fairly. They are an key part of our federal system. Tying their hands as this bill does will mean that they will not be able to respond to the unique needs of their state. This provision could result in attorneys general turning down cases they otherwise would take.

Mr. Chairman, I would encourage you to drop that provision of what otherwise if very strong legislation. Either way, I look forward to working with you on this bill and the many others we will consider this year.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 2179, THE SECURITIES FRAUD DETERRENCE AND INVESTOR RESTITUTION ACT OF 2003

THURSDAY, JUNE 5, 2003

Mr. Chairman, we meet today to examine H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act, which you recently introduced. As you know, I believe that we have an obligation to ensure that American investors are appropriately safeguarded against cases of securities fraud. I also share your concerns that to the extent possible we should prioritize efforts to compensate investors for losses resulting from securities wrongdoing.

In testimony before our Committee earlier this year, the Securities and Exchange Commission suggested a number of legislative reforms needed to enhance its ability to investigate wrongdoing, deter fraud, and compensate deceived investors. H.R. 2179 would adopt these meritorious recommendations by permitting the Commission to return more of the penalties that it collects to defrauded individuals. It would also increase the Commission's powers to collect the fines, penalties, and disgorgements that it orders. Additionally, the bill's provisions to increase access to information and raise fine levels would enhance the ability of the Commission to conduct its investigations and deter fraud.

While H.R. 2179 contains all of the recommendations proposed by the Commission earlier this year, it also contains several other additions. I have serious reservations about one of these reforms: Section 8(b). This provision would require state securities regulators to remit to the federal government any penalties or disgorgements obtained from a broker-dealer under certain circumstances.

As currently drafted, Section 8(b) poses a number of problems. Although it may be an unintended consequence, this provision would force a state that has already imposed and collected a restitution obligation to forward any additional penalty that it obtains to the federal government. In effect, the Commission would receive the state's penalty even though the state had arranged for the wrongdoer to provide full restitution to the victims. State regulators have also raised concerns that this provision would significantly limit their ability to craft appropriate remedies like mandating corrective actions in securities enforcement cases.

Moreover, by allowing the Securities and Exchange Commission to take funds from a state, Section 8(b) raises constitutional concerns. I am presently unaware of any other provision in federal law that allows the federal government to obtain the money collected by a state in an enforcement action without the state's acquiescence. One could also construe this provision as an unfunded mandate on state governments.

Historically, our dual securities regulatory system in which federal and state agencies perform specific investor protection functions has served us well. In recent cases like online and day-trading scams, penny-stock fraud, and investment banking problems with analyst research, initial action by the states eventually led to a more comprehensive response by the federal government. We should not upset this symbiotic relationship by undermining the incentives or placing fiscal constraints on the ability of states to vigorously pursue wrongdoing in the securities industry. It is therefore my hope that we will remove this provision or significantly revise it when considering this legislation in the future.

While this bill will help to ensure that some investors will receive at least partial compensation for the losses that they incur as a result of securities fraud, I continue to believe that the most meaningful route for investors to receive full restitution for their losses is through private litigation. We therefore need to ensure that investors harmed by corporate wrongdoers can seek legal redress in our Nation's courts. As the Commission notes in its recent report to Congress, investor lawsuits complement government enforcement action by providing a mechanism to compensate investors through the award of damages.

While the Securities and Exchange Commission's enforcement actions often have several aims, the objective of private litigation is exclusively to compensate injured investors. Because the ability of investors to fully recover their losses often largely depends on the use of private actions, we need to work to restore the rights of individuals to bring actions against the perpetrators of securities fraud. Amending H.R. 2179 to provide investors with greater access to the courts in cases of securities wrongdoing would achieve this worthwhile objective.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses on this important legislation. I also hope that we will not rush into a markup on H.R. 2179 before we can work together to address issues like improving the access of defrauded investors to the courts and protecting the ability of states to robustly enforce their securities laws.

Statement of Congresswoman Sue Kelly
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing: "H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003"
June 5, 2003

Thank you, Chairman Baker, for holding this hearing on important legislation that will send a clear message to all Americans that securities fraud offenders will be caught quickly, punished severely, and their ill-gotten profits will be stripped away and returned to injured investors.

Over the last two years, our country has experienced monumental and extraordinary events that have changed the nature of our work in Washington and shaped our agenda in this Committee. No one could have predicted the terrorist attacks on September 11th, or the collapse of several major corporations.

With the passage of unprecedented legislation addressing terrorism reinsurance, anti-money laundering and corporate responsibility, I am pleased to be able say that this Committee stepped up to these challenges. But as the economy begins to recover and our country continues a war to rid the world of terror, it is even more important that Congress take action to help rebuild our economy and to address eroding investor confidence. We must continue to ensure that U.S. investors – now over half of all American families – have the backing and oversight they need to return to the securities market with full faith and hope for prosperous futures.

That's why I have joined Chairmen Oxley and Baker in introducing H.R. 2179, The Securities Fraud Deterrence and Investor Restitution Act. The legislation will strengthen the SEC's ability to pursue securities law violators, increase enforcement and efficiency, and ensure investors are able to recoup losses resulting from fraud.

People need to know that there is fairness in the marketplace. Assets must be found and returned to the rightful owners – the American people who lost their retirement, tuition for their children or savings for a first home. By preventing criminals from sheltering millions of dollars in assets and enhancing the SEC's ability to trace money and relationships, the legislation will enable injured investors to recover more of their lost money. To further maximize restitution, the SEC will also be given enhanced authority to impose civil penalties, while other penalties for securities fraud have been increased significantly.

Defrauded investors have suffered enough, and any retrieved money solely belongs to them. Giving this money to States or other entities would only add insult to injury. A key provision of the legislation that I strongly support is Section 8, which requires that all fines and disgorgements are distributed back to harmed investors through the SEC Fair Funds process -- and not to the States or other entities.

I would like to thank the witnesses for appearing before the Committee. I look forward to continuing to work with you to restore investor confidence and ensure the highest level of integrity, transparency and accountability in the market.

Opening Statement
Rep. Ed Royce (CA-40)
The Securities Fraud Deterrence and Investor Restitution Act of 2003
5 June 2003

Chairman Baker, thank you for holding this hearing on H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003. I would also like to thank our distinguished witnesses for appearing today -- and I look forward to their testimony.

The bull market that surged throughout the 1990's and into the new millennium had many positive implications for the American economy and for individual American investors. It helped to attract a new, broader class of investors to our capital markets, and allowed more American households than ever before to create and build wealth.

But the ever-rising stock market also created among many corporate officials a destructive and cavalier mentality -- that misrepresenting the true financial health of their companies to drive up short-term earnings and their own personal wealth was an acceptable business practice. Lying on balance sheets and cheating ordinary investors out of their hard-earned money is not, and never was, acceptable. By passing a tough corporate governance and accounting practices bill, Congress spoke with a singular voice to corporate America that reform was needed.

Through the Sarbanes-Oxley Act of 2002 Congress established the FAIR Fund, which is a fund created to return money to defrauded investors. Creating the FAIR Fund was the right thing for Congress to do, and we need to continue to make sure that disgorged money goes to defrauded investors. I am concerned that some states have taken a different course of action by diverting settlement money to state treasuries or other purposes besides investor restitution. I commend Chairman Baker for offering legislation that helps to address this issue.

Once again, I thank Chairman Oxley and Chairman Baker for having this hearing today. It is of great importance that this committee remains vigilant in ensuring that the securities markets remain transparent and fair. I look forward to working with my colleagues to strengthen investor restitution efforts. I yield back.

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TESTIMONY OF CHRISTINE A. BRUENN

President
North American Securities Administrators Association, Inc.
And
Maine Securities Administrator

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Regarding H.R. 2179

The Securities Fraud Deterrence and Investor Restitution Act of 2003

June 5, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee,

I'm Christine Bruenn, Maine's Securities Administrator and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I commend you for holding this hearing, and thank you for the opportunity to appear before your Committee to present the states' views on H.R. 2179, The Securities Fraud Deterrence and Investor Restitution Act of 2003.

Overview

First, let me give you a brief overview of state securities regulation, which actually predates the creation of the SEC and the NASD by almost two decades. The securities administrators in your states are responsible for the licensing of firms and investment professionals, the registration of some securities offerings, branch office sales practice audits, investor education and, most importantly, the enforcement of state securities laws. Some of my colleagues are appointed by their Governors or Secretaries of State, others are career state government employees. Notably, only five come under the jurisdiction of their states' Attorneys General. We have been called the "local cops on the securities beat," and I believe that is an accurate characterization.

Securities regulatory offices are located in all 50 states and the District of Columbia, and Puerto Rico. We respond to investors who typically call us first with complaints, or request information about securities firms or individuals. State securities regulators work on the front lines, investigating potentially fraudulent activity and alerting the public to problems. Because we are closest to the investing public, state securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment related violations. We also work closely with criminal prosecutors at the federal, state and local levels to punish those who violate our securities laws.

The role of state securities regulators has become increasingly important as Americans rely on the securities markets to prepare for their financial futures. Today, we are a nation of 85 million investors. Over half of all American households are now investing in the securities markets.

Because of our proximity to the local investor, the states are an indispensable early warning system for fraud; state regulators then work with national regulators on market-wide solutions when they are required. That was the pattern followed with penny stock

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was founded in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

fraud, microcap fraud, day trading and other areas.[2] It bears repeating: the states investigate and bring enforcement actions – they do not engage in rulemaking for the national markets. That is rightly the purview of the SEC and the SROs.

We appreciate the Subcommittee's leadership in identifying some of the practices that resulted in the analyst conflict of interest inquiry, as well as the continuation of the work you started during the last Congress to enhance the SEC's criminal enforcement authority. H.R. 2179 provides securities regulators with additional tools to protect investors and strengthen the SEC's ability to penalize wrongdoers. But, even with the funding increase Congress allocated for the SEC and additional powers, the Commission can't go it alone. That is why there must be continued cooperation and shared labor among state, federal, and industry regulators.

H.R. 2179

NASAA applauds the Subcommittee for many of the provisions in The Securities Fraud Deterrence and Investor Restitution Act of 2003. We appreciate your commitment to strengthening securities regulation, and we want to work with you to reach our shared goals of enhanced investor protection and stiffer penalties for those who commit securities fraud. Given what's happened in the past few years on Wall Street and in boardrooms across the country, now is the time to strengthen, not weaken, investor protection.

NASAA fully supports giving the SEC the authority to impose civil monetary penalties in administrative cease and desist proceedings, with a right of judicial review by the court of appeals. This is consistent with state securities laws and with the Uniform Securities Acts of 1985 and 2002 (USA).

We also support significantly increasing the maximum fines that the SEC is able to impose on persons who violate Federal securities laws. Many of the current maximum penalty amounts that can be imposed on individuals who commit securities fraud are so small that they cannot have a deterrent effect on the violators. At a time when some corporate executives are making $50 million a year or more, these larger fines are critical if they are to have an effective deterrent or punitive impact on wrongdoers. The current low penalties could be seen by some not as a deterrent but simply a "cost of doing business."

Another provision we would support allows the SEC to seek financial records from a financial institution without first having to notify the customer. This is consistent with many state laws that allow regulators to subpoena bank records without notification to the customer if a risk of flight or dissipation of assets exists. These records can be transferred to any government authority under certain conditions without notification to the customer.

[2] See State/Federal Dynamic Chart Attached

Section 8(b)

Although NASAA supports the vast majority of the provisions in H.R. 2179, I must express our deep concerns regarding Section 8(b). First, let me say that we share your goal of returning more funds to defrauded investors. We agree that restitution should be a priority of regulators. In fact, a primary and routine objective of state securities regulators is to obtain restitution for investors as part of enforcement actions. For example, in the 2001/2002 reporting period, state securities regulators collectively obtained orders for over $309 million in restitution. During the same period, roughly $71 million was ordered in fines and penalties.

To make the point that restitution is a priority, let me illustrate with some statistics from several states. In my home state of Maine, during the period from July 1, 2002 through May 31, 2003, my agency participated in the return of over $2.8 million to investor victims while collecting, apart from the Merrill Lynch settlement, only $16,000 in penalties to the general fund[3].

Data for Pennsylvania reflects the same priority. For Fiscal Year 2003 to date, the Pennsylvania Securities Commission oversaw the payment of $8.2 million in restitution/disgorgement and the collection of just $130,057 in civil penalties.

And during 2002, enforcement actions by the Arizona Securities Division led to payment of $222 million in restitution to investor victims and the collection of a comparatively modest $142,780 in penalties.

While we agree on the priority of restitution, there are provisions of H.R. 2179 that raise practical and public policy issues as well as the specter of unintended consequences that could actually harm investors.

We believe it would be bad public policy to attempt to direct a state authority to remit a civil penalty or disgorgement ordered in a state case to a federal governmental body for distribution. These funds rightfully belong to the investors or citizens in the state. Decisions regarding the use of penalties are best made by state legislatures and regulators so they can be tailored to the unique circumstances of each jurisdiction.

Under our reading of H.R. 2179, the states would lose control over the disposition of civil penalties obtained through efforts of state officials who are paid with state funding. Some states direct penalty monies back to enforcement activities and use the money to hire additional investigators and for other law enforcement purposes; others direct funds to investor education; and some to go to the general fund. All of these spending priorities serve the public good.

[3] The civil penalty examples for Maine, Pennsylvania and Arizona do not include the fines paid to those states in connection with the 2002 Merrill Lynch settlement.

Moreover, Section 8(b) has the potential to stifle state enforcement actions designed to protect investors. If the states are restricted in their ability to impose remedial actions they believe are necessary to curtail wrongdoing in their jurisdiction, they may be reluctant to impose beneficial remedies for fear of losing funds and support from within the state. This could conceivably have a chilling effect on us doing our jobs of protecting investors in your states.

State securities regulators apply a variety of sanctions when taking enforcement actions against brokers or dealers, depending upon the specific facts of each case. Remedial sanctions are an important enforcement tool in addition to restitution and monetary penalties. Where state securities regulators investigate and resolve enforcement cases using these remedies, their judgment regarding appropriate outcomes should be respected and supported.

For example, our routine remedies for selling unsuitable investments are to negotiate with the firms to return losses to investors and require the firm and/or the sales representative to address the underlying causes of the unsuitable investment. Those remedies often include having the branch manager review trades and compare them with the customer's investment objectives; requiring the representative to take specialized training; or requiring compliance or management procedures to anticipate problems.

In a case I investigated several years ago, a broker was able to steal money from his clients by asking their mutual fund companies to redeem shares and send the check to the client. The broker told the clients the checks were sent by mistake and should be returned. When the clients brought him the checks, he deposited them into his own account. My office required the firm to make restitution to the defrauded investors and institute new procedures to detect unusual levels of mutual fund redemptions. These specialized requirements for that case clearly went beyond what is required by federal law, but they were appropriate and carefully targeted remedies in that case.

The difficulty with Section 8(b) arises where states find it appropriate to combine these important remedial sanctions with penalties and restitution. Let's say a state securities regulator found that a branch office of a broker-dealer in its state had been selling an unusually high percentage of risky investments to elderly investors. The state may order the broker-dealer to make rescission offers to all investors, fine the broker and require the broker-dealer, for a fixed period of time, to keep a separate file on all transactions with senior citizens and provide reports to the Commissioner on such transactions. A review of Section 8(b) would suggest that the fine would have to be sent to the SEC for possible addition to the FAIR Fund. The troubling aspect of this illustration is that the state would have to send the fine collected to the SEC, even though the state had already arranged for the firm to make restitution to the victims.

Finally, the legislation leaves some open questions. It is unclear if it would apply if a state imposed the same remedial measures that were imposed in a parallel federal enforcement proceeding, where both the state and federal orders went beyond the requirements of federal law. The uncertainty in the mechanics of the bill points to another problem: when the state, the SEC and the industry respondent in a given case disagree on whether the provisions of Section 8(b) are triggered, how is that impasse to be resolved? This question suggests increased conflict between all three players, and resources being wasted in resolving such disputes.

In contrast with this scenario is the very positive experience in the recent global settlement with the leading Wall Street firms. In my view, the global investigation and agreement was a model for state-federal cooperation that will serve the best interests of investors nationwide. We must be able to leverage our resources and continue to work together on such cases. The federal-state-industry regulatory relationship is like a three-legged stool; if one leg is weakened, it can destabilize the entire structure. With 85 million investors relying on our securities markets to meet their financial goals and on regulators to keep those markets well policed, we can't afford to undermine our complementary regulatory system.

To sum up our concerns, while we wholeheartedly support the provisions in HR 2179 to strengthen the SEC's enforcement authority, it appears to be inconsistent policy to enhance the SEC's enforcement powers while at the same time inhibiting the states' options in enforcement actions.

Closing

Mr. Chairman and members of this Subcommittee, in closing, I want to repeat our support of the goals of this legislation. The SEC needs more authority and resources and those who break our securities laws should pay a higher price than they do today. But we are deeply troubled that this legislation, while strengthening the SEC, could weaken and limit the efforts of state securities regulators to protect investors in your states. Based on my experience as a securities regulator for the past 16 years, I believe that now is the time to strengthen, not weaken our unique complementary system of state, industry and federal regulation. Eighty-five million investors -- many of them wary and cynical -- expect us to remain vigilant, to work together, to stay the course and -- to make sure that Wall Street puts investors first. We cannot -- and we will not -- let these millions of investors down.

I pledge the support of the NASAA membership to work with you and your Subcommittee to provide you with any additional information or assistance you may need. Thank you for the opportunity to testify.

STATE/FEDERAL DYNAMIC:
HOW STATE DETECTION OF INVESTOR PROTECTION ISSUES LEADS TO NATIONAL RESPONSE

Issues Identified by State Securities Regulators	Problem	National Response
1989 - States determined Penny Stock offerings by newly formed shell companies to be per se fraudulent.[1] These "blank check" companies had no business plan except a future merger with an unidentified company.	**$2 billion/yr. Losses in Penny Stocks**[2]	1990- Congress passed Penny Stock Reform Act which mandated SEC to adopt special rules governing sale of Penny Stocks (<$5.00 per share) and public offerings of of shares in Blank Check companies (SEC Rule 419).[3]
1991 - States found that rollups of poorly performing public limited partnerships disadvantaged individual investors by not providing meaningful dissenters' rights.	**Lack of dissenters' rights**	1993- Congress passed the Limited Partnership Rollup Act which mandated that NASD adopt rules containing specific provisions to protect dissenters' rights.[4]
1996-97 - 33 States participated in sweep of 15 broker-dealer firms that specialized in aggressively retailing low-priced securities to individual investors. States found massive fraud in firms' manipulation of shares of start-up companies, most of which had no operating history.	**$6 billion/yr. Losses in Micro-cap Stocks**[5]	1997-98- Congress held hearings on fraud in the micro-cap securities markets (shares selling between $5-10). 2002 - Congress passed Sarbanes-Oxley Act which made certain state actions a basis for federal statutory disqualification from the securities industry.[6]

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[1] *Resolution of the North American Securities Administrators Association Declaring Blank Check Blind Pool Offerings to be Fraudulent Practices* (4 April 1989), NASAA Reports (CCH) ¶7028.

[2] *NASAA Investor Alert*: Penny Stock Fraud (December 1989).

[3] 15 U.S.C. §78o(g); 15 U.S.C. §77g(b)(1).

[4] 15 U.S.C. §78o(b)(12) and (13).

[5] Opening Statement of Senator Susan Collins, Chair, Senate Permanent Subcommittee on Investigations (22 September 1997).

[6] U.S. Senate Permanent Subcommittee on Investigations (22 September 1997 and 10 February 1998); 15 U.S.C. §78o(b)(4)(H); 15 U.S.C. §80b-3(e).

1996-97 - States were the first regulators anywhere to issue uniform interpretative guidance on use of Internet for legitimate securities offerings and dissemination of product information by licensed financial services professionals.[7]	**Risks of Securities offerings on The Internet**	1998- SEC issued interpretative guidance based on the States' Model on the use of Internet for securities offerings and dissemination of services and product information by licensed financial services professionals.[8]
1999 - In a report on trading of securities on the Internet, States found that investors did not appreciate certain risks, including buying on margin and submitting market orders.[9]	**Risks of Online Trading**	2001- SEC approved a new NASD rule requiring brokers to provide individual investors with a written disclosure statement on the risks of buying securities on margin.[10]
1999 - In a first-ever report on individuals engaged in day trading, States found that day trading firms failed to tell prospective investors that 70% of day traders would lose their investment while the firm earned large trading commissions.[12]	**Risks of Day Trading**	2000- SEC approved new NASD rules making day trading firms give written risk disclosure to individual investors.[11] 2001 - SEC approved new NASD and NYSE rules governing margin extended to day traders.[13]

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[7] *Resolution of the North American Securities Administrators Association Regarding Securities Offering on the Internet* (7 January 1996), NASAA Reports (CCH) ¶7040; *Resolution of the North American Securities Administrators Association Regarding Internet Advertising of Information on Products and Services* (27 April 1997), NASAA Reports (CCH) ¶2191.

[8] *Statement of the Commission Regarding use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore,* U.S. Securities and Exchange Commission, Release No. 33-7516 (23 March 1998).

[9] *From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry*, Office of the New York Attorney General (22 November 1999).

[10] *Delivery Requirement of a Margin Disclosure Document to Non-Institutional Customers*, U.S. Securities and Exchange Commission, Release No. 34-44223 (26 April 2001).

[11] NASD Rules 2360 and 2361.

[12] *Report of the NASAA Project Group on Day Trading*, North American Securities Administrators Association (August 1999).

[13] NASD Rule 431; NYSE Rule 2520.

TESTIMONY

OF

STEPHEN M. CUTLER, DIRECTOR
DIVISION OF ENFORCEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE SECURITIES FRAUD DETERRENCE AND INVESTOR RESTITUTION ACT, H.R. 2179

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

JUNE 5, 2003

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Testimony

of

Stephen M. Cutler

Director, Division of Enforcement

U.S. Securities and Exchange Commission

Concerning

The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179

Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services

June 5, 2003

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission, I am pleased to be here to testify before you. In inviting me here today you have asked that I discuss the Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179 (the "Bill"), which recently was introduced by Chairmen Oxley and Baker, as well as other members of the Subcommittee.

As you know, I testified before the Subcommittee last February concerning the findings and legislative recommendations contained in a number of reports the Commission submitted to Congress pursuant to the Sarbanes-Oxley Act. H.R. 2179 incorporates a number of the proposals from the Commission's reports, which, if adopted, would strengthen the Commission's enforcement capabilities and assist defrauded investors. These provisions would greatly enhance the effectiveness of the Commission's enforcement investigations, and significantly improve the Commission's ability to prosecute wrongdoers, collect money from them, and return it to injured investors. Accordingly, I commend Chairmen Oxley and Baker, and the other sponsors of this legislation, for their initiative and commitment in introducing this very useful and potentially far-reaching bill.

I. Removing state law barriers to Commission debt collection

Section 2 of the Bill would improve the Commission's collection efforts by eliminating state laws that enable defendants to shield their assets from Commission judgments or orders in their homesteads. Specifically, it would authorize the Commission to force the sale of any property owned by a person against whom it obtained a judgment or order based on fraudulent conduct in order to satisfy the judgment or order, notwithstanding any state law that protects homestead property.

The homestead exemption arises in Commission litigation when a defendant fails to pay disgorgement ordered, and the Commission files an action in federal district court asking the court to hold the defendant in contempt of court for that failure to pay. In contempt actions, defendants often assert that they cannot pay some or all of the owed disgorgement because they lack sufficient assets. As a result, during the contempt proceeding, the court must determine which of a defendant's assets are available to pay disgorgement. In the case of exempted assets, such as a homestead, the court has considerable discretion in determining whether or not that exempted asset must be used to pay disgorgement.

The Commission encounters cases where securities law violators can rely on state law homestead exemptions and other protections to shield their assets from collection. All states have statutes that exempt certain property from collection by creditors, including the Commission. Some defendants use these exemptions to shelter their assets from collection. For example, in certain states, defendants can shelter millions of dollars in their primary residences — using the "homestead" exemption — that might otherwise be available for collection by the Commission. Currently, when trying to collect disgorgement, the Commission's staff, at best, must engage in protracted litigation to avoid state law exemptions and at worst may be precluded from reaching assets that should be returned to the victims of securities fraud.

Two examples of difficulties encountered by the Commission are illustrative of the effects of the homestead exemption:

- The case of SEC v. American Automation, Inc., et al. involved the fraudulent sale of $4.2 million in unregistered stock to at least 450 investors in several states by defendants Kendyll R. Horton, Hazel A. Horton, Merle B. Gross, and Jayne Roose. The Commission obtained summary judgment against defendant Hazel Horton, and on May 31, 2002, the district court ordered

Horton to pay \$4.58 million in disgorgement. When Horton failed to pay, the Commission filed an action in contempt against her. Despite the favorable precedent in this jurisdiction (the Northern District of Texas), the court did not allow the Commission to use Horton's homestead to satisfy the judgment. The court allowed Horton to remain in her homestead (until she voluntarily moves or dies) even though she had violated an asset freeze by mortgaging the homestead and had used investor funds to improve the homestead. Hazel Horton remains in her home today.

- In SEC v. Great White Marine & Recreation, Inc., et al., the Commission charged defendant Alvis Colin Smith, Jr. with orchestrating a \$10 million pump-and-dump stock scheme. In 1999, the Commission filed suit against Smith and his related corporation, Great White Marine and Recreation, Inc. The Commission alleged, among other things, that Great White and Smith had offered and sold unregistered shares of Great White's stock using false statements in press releases, promotional brochures, Internet website postings, and in a Commission filing. On June 19, 2001, the district court entered a final judgment against Smith, requiring him to disgorge \$3 million, three lakeside lots, several vehicles, and various other assets. Although Smith did disgorge some of the assets, he failed to deliver others. The Commission moved for contempt, seeking his homestead. The Commission presented evidence tracing funds from the fraud directly to repayment of the mortgage on the homestead. On October 12, 2001, the district court found Smith to be in contempt of court and ordered him incarcerated until he disgorged several vehicles and his interest in the residence. In addition, the court strongly expressed the view that Smith's wife (who was not named in the Commission's action) should be allowed to keep at least her interest in the homestead. Accordingly, a court-appointed agent settled by allowing Smith's wife to keep approximately one-half of the equity in the homestead. Smith subsequently pled guilty on related criminal charges and is again incarcerated.

In sum, by overriding state homestead laws, Section 2 of H.R.2179 would make more assets available for recovery by the Commission and for return to defrauded investors. In addition, Section 2 should increase the deterrent value of Commission enforcement actions against wrongdoers by depriving them of more assets.

II. Civil enforcement provisions

Section 3 of the Bill contains several important provisions to strengthen the Commission's enforcement program.

A. Providing penalties in administrative cease-and-desist proceedings

Section 3(a) would enhance the effectiveness of the Commission's cease-and-desist proceedings by authorizing the Commission to impose money penalties in these proceedings. Currently, the Commission has two primary means of seeking civil penalties: in administrative proceedings against entities and persons directly regulated by the Commission, such as broker-dealers or investment advisers; and in federal court actions against any entity or person. The Commission also has authority to seek remedies other than civil penalties against any entity or person in an administrative proceeding.

The result of this patchwork is that in some circumstances the Commission must file two separate actions against the same entity or individual to obtain the appropriate array of relief. For example, if the Commission finds cause to order a company or a corporate officer to cease-and-desist from violating the securities laws but also seeks to impose a civil money penalty, two separate actions concerning the same facts must be filed. Similarly, if the Commission wished to employ its new authority to seek an officer and director bar administratively, and also wished to seek a money penalty from the corporate officer, it would have to file two separate actions. Moreover, under current law, if the Commission charges a respondent with "causing" another party's violation of the securities laws (a concept similar to aiding and abetting) in an administrative cease-and-desist proceeding, the Commission can impose a monetary penalty only in very limited circumstances.[1]

By granting the Commission additional authority to seek penalties in cease-and-desist proceedings, Section 3(a) would eliminate inefficiency, give the Commission added flexibility to proceed administratively, and strengthen the Commission's ability to

1 The Commission may in limited circumstances seek a penalty in a cease-and-desist proceeding against anyone who was a cause of a violation of certain provisions of Section 10A of the Securities Exchange Act of 1934.

hold those who assist in violating the securities laws financially accountable for their actions. This provision also would provide appropriate due process protections for subjects of administrative penalty proceedings by making imposition of a civil penalty in an administrative cease-and-desist proceeding appealable to a federal court of appeals.[2]

B. **Increasing penalty amounts in civil actions and certain administrative proceedings**

Section 3(b) would significantly increase the amount of penalties that the Commission may seek for violations of the federal securities laws in many types of actions. Currently, in non-insider trading cases, the Commission may obtain penalties for each violation up to the greater of (1) \$6,500 to \$600,000 or (2) the defendant's gross amount of pecuniary gain as a result of the violation.[3] The size of the penalty depends on the nature of the wrongful conduct, whether the penalty is sought against a natural person or entity, and whether the conduct involved substantial loss or risk of substantial loss by investors. As conduct becomes more egregious, the maximum penalty amount increases. Section 3(b) would increase the penalty amounts the Commission may seek in civil actions and certain administrative proceedings. Under the proposed legislation, penalties could range in size from \$10,000 to \$2 million per violation.

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2 As noted, Congress recently expanded the Commission's authority to obtain another type of relief in an administrative context in Section 1105 of the Sarbanes-Oxley Act, which granted the Commission authority to impose officer and director bars in administrative cease-and-desist proceedings.

3 *See, e.g.,* Section 21(d)(3)(B) of the Exchange Act.

Increasing the size of penalties is an important step in achieving the desired deterrent effect under the securities laws, especially in light of the exponential growth of our capital markets during the last ten years. In addition, by using the Fair Fund provision contained in Section 308(a) of the Sarbanes-Oxley Act, the Commission may more fully compensate injured investors if larger penalties are paid.

C. **Improving access to bank and other financial institution records**

Section 3(c) would eliminate the existing requirement that customers of banks and other financial institutions be notified of Commission subpoenas seeking access to their financial records, and so would enhance the Commission's ability to obtain and use account information, to quickly and effectively trace and identify funds, and to thereby uncover relationships among suspected wrongdoers. Specifically, under the provision, banks would be authorized to provide information about customers' accounts on an expedited basis, and without notifying their customers in certain circumstances.

The Commission requests bank records when it has reason to suspect that the passage of money among persons or entities may relate to violations of the securities laws. Quickly unraveling such relationships, and identifying any assets obtained or transferred in connection with unlawful activity, are critical to the Commission's ability to obtain orders freezing assets. Delay in obtaining these records almost invariably benefits the wrongdoers and may deprive investors of any meaningful opportunity for redress.

Current law generally requires that, prior to obtaining bank records, the Commission provide notice to the account holder and wait ten to fourteen days to permit the customer to contest the Commission's request. If the customer does file a challenge, the federal courts will frequently take four to six months to resolve the challenge, even though the Commission invariably has met the standard that the requested records be relevant to a legitimate law enforcement inquiry.[4]

During the required notice period, a person may hide assets, destroy evidence, or even flee the jurisdiction. While current law permits the Commission to seek court authorization to obtain bank records without first notifying the customer, this procedure may require the expenditure of significant staff resources and result in substantial delay — which also compromises important enforcement objectives.

Section 3(c) would address both the notice and delay problems by allowing the Commission the discretion – though only in those cases in which it already has authorized a formal investigation – to obtain bank records without notice to the customer. This change would enable the Commission to more quickly uncover securities law violations and more effectively enforce the securities laws by obtaining appropriate asset freezes and preserving assets for the benefit of defrauded investors.

[4] The Commission responds to challenges by showing that its investigative subpoenas are issued in connection with a formal investigation.

III. Removing barriers to the production of privileged information

Section 4 of H.R. 2179 would allow a person to provide privileged information to the Commission without waiving that privilege as to other persons. If adopted, this provision would help the Commission gather evidence in a more efficient manner by eliminating a strong disincentive to parties under investigation to voluntarily produce to the Commission important information.[5]

Voluntary production of information that is protected by the attorney-client privilege, other privileges, or the work product doctrine greatly enhances the Commission's investigative efforts, and in some cases makes them more efficient. Particularly in financial fraud investigations, the Commission may learn of the existence of an internal inquiry conducted by an issuer's attorneys. The issuer may be willing to share such information with the Commission's staff if the issuer could otherwise maintain the privileged and confidential nature of the information. Currently, a person who produces privileged or otherwise protected material to the Commission runs a risk that a third party, such as an adversary in private litigation, could obtain that information by successfully arguing that the production to the Commission constituted a waiver of the privilege or protection.[6]

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5 Of course, the Commission must always be free to disclose in an enforcement proceeding the documents produced to it (even pursuant to a confidentiality agreement) if the Commission determines that it is necessary in furtherance of the discharge of its duties and responsibilities. This would be true even if such use (as distinct from the mere production of the documents) resulted in a waiver of the privilege.

6 *See., e.g., In re Columbia/HCA Healthcare Corporation Billing Practices Litigation*, 293 F.3d 289 (6th Cir. 2002), *petition for cert. filed*, 71 U.S.L.W. 3429 (Dec. 9, 2002) (finding waiver of privilege where company had previously produced documents to government agencies under confidentiality agreement). The Commission has appeared as amicus curiae in a number of state court cases to urge that a defendant

This situation creates a substantial disincentive for anyone who might otherwise consider providing protected information.

Section 4 would help the Commission's enforcement staff gather information in a more efficient manner. More expeditious investigations could lead to more prompt enforcement actions, with a greater likelihood of recovery of assets to return to investors.

IV. Improving access to grand jury information

Section 5 of the Bill would enhance the Commission's access to grand jury information. Specifically, it would authorize the Department of Justice, subject to judicial approval in each case, to share grand jury information with the Commission staff in more circumstances and at an earlier stage than is currently permissible. The judicial approval would be based on a finding of the Commission's "substantial need" to be informed. Federal and state financial institution regulators already have the kind of access to grand jury information that Section 5 would provide to the Commission.[7]

Under existing criminal procedure law applicable to the Commission, in most cases the Commission's staff will not receive access to grand jury information, and therefore the staff must conduct a separate, duplicative investigation to obtain the same information already in the hands of federal criminal authorities. The "grand jury secrecy

who produced such material to the Commission subject to a confidentiality agreement has not waived the protection for attorney work product.

[7] *See* 18 U.S.C. 3322.

rule" results in an inefficient use of government resources, and places additional burdens on private persons who must provide essentially the same documents and testimony in multiple investigations.

Enacting Section 5 would make it possible for the Commission to efficiently receive timely information required to complete investigations and prosecutions, and avoid unnecessary duplication of government efforts.

V. Providing for nationwide service of civil trial subpoenas

Section 6 of the Bill would authorize the Commission to make nationwide service of trial subpoenas available in the Commission's civil actions filed in federal district court.

Under current law, the Commission may issue trial subpoenas in federal court actions only within the judicial district where the trial takes place or within a "100-mile bulge" from the courthouse. When witnesses are located outside of the district court's subpoena range and fail to volunteer to appear at trial, the staff must take the witnesses' depositions, and then use those depositions at trial. Such deposition testimony is more expensive and less effective than live testimony.

The Commission currently has authority for nationwide service in administrative proceedings. The Commission's favorable experience in the administrative forum supports extending those provisions to civil actions filed in federal district courts. Moreover, other federal agencies with comparable missions have long had such nationwide service authority.[8]

Granting the Commission authority to serve trial subpoenas nationwide would provide substantial advantages. The Commission would save significantly on the costs of creating and presenting videotaped deposition testimony, on travel costs, and on staff time due to the elimination of unnecessary depositions. It would also provide the benefit of more frequent live witness testimony before trial courts in Commission cases.

VI. Authorizing the Commission to contract with private counsel to collect debt

Section 7 of the Bill expressly authorizes the Commission to retain private legal counsel to collect debts owed as a result of Commission judgments or orders, and to negotiate the appropriate fee to pay such private legal counsel.

This is a particularly important aspect of H.R. 2179. Any successful collection program must have a strong litigation component; current law, however, allows the

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8 Congress has enacted more than ten statutes that authorize the issuance of trial subpoenas by district courts for witnesses beyond the limitations found in Federal Rule of Civil Procedure 45 (which applies to the SEC currently). The exceptions include: (1) the Clayton Antitrust Act, 15 USCA 23; (2) RICO, 18 USCA 1965(C); (3) the Bank Holding Company Act, 12 USCA 1974; (4) the Voting Rights Act of 1965, 42 USCA 1973l(d); (5) the Federal Food, Drug and Cosmetic Act, 21 USCA 337; (6) the Federal Election Campaign Act, 2 USCA 437g(a)(7); (7) the Ethics in Government Act, 28 USCA 1365(b); (8) the Clean Air Act, 42 USCA 7523(b); (9) the Egg and the Poultry Products Inspection Acts, 21 USCA 467c and 1050; (10) the Federal Hazardous Substance Labeling Act, 15 USCA 1268; (11) the Public Utility Regulatory Policies Act, 15 USCA 717z(g)(2)(B).

Commission to contract for non-litigation collection services only. This is in contrast to the Department of Justice, which does have authority to hire private counsel to collect judgments. Thus, collection litigation must be carried out by SEC staff, who are diverted from investigating and stopping other violations of the federal securities laws. Moreover, collection of disgorgement judgments requires knowledge of a variety of state execution procedures. Requiring Commission enforcement staff to become proficient in the law and procedures of multiple jurisdictions further diverts staff time and attention from their principal mission of enforcing the federal securities laws.

Section 7 would enable private attorneys to conduct litigation for the Commission under the Federal Debt Collection Procedures Act ("FDCPA") to collect judgments. In addition, private attorneys hired by the Commission would conduct litigation tailored to the collection of disgorgement, including filing contempt proceedings and using state law procedures required to execute on disgorgement judgments.

If adopted, Section 7 would conserve staff resources for major mission functions — investigating and stopping securities violations – while potentially increasing amounts available to recompense injured investors. Further, local attorneys with expertise in the complexities of state collection laws should provide quicker and more efficient returns.

VII. Amendments to the Fair Fund provision

Section 8 of H.R. 2179 contains three substantive amendments to the Fair Fund provision, Section 308(a) of the Sarbanes-Oxley Act.

A. Broadening Fair Fund's application

Section 8(a) would amend the Fair Fund provision by allowing the Commission to use *any* penalties paid as a result of Commission actions to compensate investors injured by defendants in such actions.

The Fair Fund provision, Section 308(a) of the Sarbanes-Oxley Act, was a groundbreaking measure to help the Commission return more funds to defrauded investors. The Fair Fund provision changed the law to permit penalty amounts collected to be added to disgorgement funds in certain circumstances. However, as enacted, the provision only permits the Commission to add penalty amounts to disgorgement funds when a penalty is collected from the *same defendant* that has been ordered to pay disgorgement. There are cases, however, where some defendants may <u>not</u> be ordered to pay disgorgement and it would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who <u>are</u> paying disgorgement) to harmed investors in that case. Indeed, in some cases, the Commission may not obtain disgorgement from <u>any</u> defendant, but may obtain civil money penalties. In such cases, it might nevertheless be feasible to create a distribution fund for the benefit of victims in that case. Section 8(a) would make it possible to return these additional funds to investors.

B. **State judgments or orders**

Section 8(c) provides that if a state establishes, by agreement or judgment, a requirement for brokers or dealers that is different from the requirements of the federal securities laws, then penalties or disgorgement paid as a result of the agreement or judgment shall be remitted to the Commission for distribution to injured investors pursuant to the Fair Fund provision.

Congress long ago created a dual securities regulatory system in which both federal and state agencies serve specific, valuable functions in protecting investors. At the same time, there is little question that the imperative to achieve consistent regulation of the U.S. securities markets dictates the need for a single, dominant, national regulator. This is not meant to suggest, however, that the states should be relegated to the backseat of our regulatory system. State securities agencies have played — and should continue to play — a significant role in making our securities markets the most respected and trusted in the world. The more resources — federal and state — we can bring to the cause of maintaining this status, the better off investors are.

During the past year, the overlapping responsibilities of federal and state securities agencies have been vividly illustrated by the joint investigations of research analyst practices undertaken by the Commission, the self-regulatory organizations, and the states. The Commission believes it is important to return funds collected through enforcement actions to harmed investors whenever possible. Accordingly, the Commission and other federal regulators determined to use their portion of the monies obtained in the global research analyst settlement to recompense investors. We invited the states participating in the global settlement to contribute their portions of the settlement payments to the federal distribution fund as well. Thus far, one state – the State of Missouri – has responded affirmatively to our invitation and has expressed an interest in working with us to distribute disgorgement/penalty amounts to investors.

The policy question of whether Section 8(c) strikes the appropriate balance between state and federal securities enforcement power is appropriately Congress's and not the SEC's to resolve. Moreover it is one that may require further study. The Sarbanes-Oxley Act Fair Fund provision has been in effect for less than one year, and our experience in distributing funds from the global settlement and other cases pursuant to the Fair Fund provision may yield important lessons for this Committee. In addition, in assessing Section 8(c), it is important to determine how it would affect incentives to, and fiscal constraints on, states' ability to pursue securities-related misconduct aggressively and vigorously. Should you decide that Section 8(c) does strike this balance, there are also some technical drafting issues that we would be pleased to discuss.

C. **Investor education and financial literacy**

In situations where it is not feasible to distribute all disgorgement funds or Fair Funds to victims of a violation, Section 8(d) of H.R. 2179 provides that the Commission may use undistributed amounts in such funds to educate investors. Specifically, it authorizes the Commission to seek or issue an order directing that such undistributed monies be used for investor education programs to be administered by an established not-for-profit or governmental organization.

Financial literacy is a crucial foundation for participation in our capital markets. People need to be able to "read, write and speak" basic financial concepts in order to make informed decisions about investments. In addition, the Commission's enforcement program benefits from financial literacy because an educated investor is the first line of defense against fraud. A financially literate investor can ask better questions about a potential investment and is better able to discern investment claims that are just "too good to be true." Thus, investor education is an important tool to help prevent securities fraud.

VIII. Conclusion

The Commission supports Congressional action to improve the Commission's enforcement capabilities. Certain elements of the proposed Securities Fraud Deterrence and Investor Restitution Act, in particular, would greatly assist the Commission in fulfilling its enforcement mission to prevent, detect and prosecute securities law violations, and to provide recompense to injured investors. We look forward to working with this Subcommittee in the future to further these important goals.

NASD

Testimony

of

Mary L. Schapiro

NASD Vice Chairman and President
Regulatory Policy and Oversight

On H.R. 2179

Before
the
Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises

United States House of Representatives

June 5, 2003

Mr. Chairman and Members of the Subcommittee:

NASD would like to thank the committee for the invitation to submit this written statement for the record in support of H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act.

NASD

NASD, the world's largest securities self-regulatory organization, was established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines those firms for compliance with NASD rules and the federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our market integrity responsibilities include examination; rulewriting and interpretation; professional training; licensing and registration; investigation and enforcement; dispute resolution; and investor education. We monitor all trading on The NASDAQ Stock Market -- more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors -- at least half of whom are unaffiliated with the securities industry.

NASD supports H.R. 2179. These amendments to the federal securities laws will strengthen the hand of the Securities and Exchange Commission (SEC) in a number of important ways. At a time when more than 80 million American investors and many others are looking to regulators, legislators, and industry leaders to meet our collective responsibilities to protect investors and strengthen market integrity, we endorse the bill's twin goals of maximizing the restitution returned to injured investors and strengthening the tools available to our nation's federal securities regulator.

Role of the FAIR Fund in the Global Settlement

On April 28, 2003, the SEC, the North American Securities Administrators Association (NASAA), the New York Attorney General, the New York Stock Exchange (NYSE), and NASD reached an agreement with ten of the nation's largest investment banks to resolve issues of conflicts of interest involving research analysts and investment banking. This "global settlement" concluded a joint investigation by the regulators into the undue influence of investment banking interests on securities research at brokerage firms. The settlement, along with new rules and other enforcement cases that already have been filed or are being investigated, will go a long way toward ensuring that these problems are effectively addressed -- not only at the large investment houses that are party to the settlement, but throughout a diverse industry.

During the negotiations on the global settlement, the federal regulators were able to use the FAIR Fund (Federal Account for Investor Restitution Fund), established in the Sarbanes-Oxley legislation last year at the urging of Chairman Baker, as the mechanism to return civil penalty funds to injured investors. Under the terms of the settlement, the firms agreed to pay a total of $1.4 billion. Of this amount, $387.5 million in penalties and disgorgement will be paid to the FAIR fund to benefit injured customers of the firms. The states will receive an equal amount, $487.5 million, to use as they deem appropriate. The firms will also make payments totaling $432.5 million to fund independent research, and payments of $80 million from seven of the firms will fund and promote investor education.

Of the $80 million that will be paid for investor education, the SEC, NYSE and NASD have authorized that $52.5 million will be placed in an Investor Education Fund that will develop and support programs designed to equip investors with the knowledge and skills necessary to make informed decisions. The remaining $27.5 million will be paid to state securities regulators and will be used by them for investor education purposes.

The global settlement demonstrated extraordinary cooperation among our nation's securities regulators. Each of the regulators involved play an important role in policing our securities markets: the SEC has overall responsibility for setting the structure of securities regulation; self-regulatory organizations like NASD oversee day-to-day operations of the market and enforce the rules; and the state securities regulators are our partners in enforcement, adding more "cops on the beat" to securities regulation in this country.

Those of us who played a role in the settlement wanted to underscore four basic principles:

- One, to change the way Wall Street does business.
- Two, to get maximum recovery to investors by using the FAIR fund.
- Three, to fund investor education in innovative and effective ways.
- And last but not least, to make certain that the evidence we uncovered would be made available to investors so that they would be able to seek recovery of their losses through meritorious arbitrations and court proceedings.

H.R. 2179

The changes to the FAIR fund included in H.R. 2179 are important for our shared goals of maximizing recovery to investors.

One way to rebuild investor confidence is by assuring investors that when they have been defrauded and a firm is forced to pay penalties, the money that is paid will go to restitution or, more generally, for investor protection, through securities enforcement or education. Money collected by government regulators in securities enforcement actions should go back to those who were victimized by the wrongdoing or, where the injured are not readily identifiable or if the case involves a matter where there are no discernable or identifiable victims, the money should be used for investor protection or securities regulatory purposes. A centralized fund such as that envisioned in Section 8 of the bill is a highly effective tool for this purpose.

And Section 8 will not diminish the effectiveness of federal or state regulators in pursing wrongdoing.

Another provision that investors will find helpful as they attempt to collect from those who have defrauded them is the elimination of the homestead exemption contained in the bill. By authorizing the SEC to foreclose on homes to satisfy judgments in securities cases, the bill helps prevent situations where illicit profits wind up in the pockets of wrongdoers, while investors' pockets remain empty. This is an important provision for solving the classic problem of crooks building massive homes to shelter ill-gotten gains and keep from paying judgments to injured investors.

Other provisions in the bill will significantly change the calculus made by some companies and individuals, who currently reason that paying SEC penalties is simply a cost of doing business and not a public recognition that they violated investor protection laws. Giving the SEC authority to impose monetary penalties in cease and desist proceedings, and significantly increasing the maximum fines that courts can impose for violations of the securities laws, sends a strong signal to companies and individuals. We support the greater efficiency provided by allowing the SEC to seek civil monetary penalties from non-regulatees in an administrative proceeding, without having to go to federal court. Facilitating the SEC's collection of financial records will be helpful and the requirement that a formal order be in effect before a subpoena for such records is issued without notice will protect against possible abuse.

Expanding the SEC's existing authority for nationwide service of process to include subpoenas issued in federal court actions removes an impediment to the SEC's efficiency, speed, and ability to build compelling cases through the use of live testimony. In terms of litigating securities fraud cases, there is nothing more compelling than live witnesses. With this provision in effect, the SEC will be able to present stronger cases that will have more impact with judicial fact finders.

Likewise, Section 4, authorizing the SEC to accept voluntary production of otherwise-privileged information to assist in an investigation without the provider waiving the privilege should expand the SEC's access to internally directed reports and analysis, thus speeding a fair resolution to SEC investigations by eliminating time-consuming negotiations and discussions over privilege.

NASD can attest to the difficulty of debt collection resulting from securities litigation. Granting the SEC the authority to hire private lawyers for debt collection means that scarce government resources will not have to be diverted to collection activities.

All these provisions will result in aiding investors as they seek to recover their losses.

NASD Dispute Resolution

NASD helps investors recover losses through our arbitration forum, in which we strive to ensure that there is a fair and cost-effective process for resolving disputes between investors and brokerage firms. NASD has administered securities arbitration cases for more than 30 years, and today we administer more than 90 percent of all securities arbitrations in the U.S. If a firm fails to pay arbitration awards, it is suspended from membership in NASD and thus from the securities industry.

Arbitration is a faster, more convenient and less costly alternative to court litigation. NASD's mediation forum successfully reaches a settlement in nearly eighty percent of cases with an averaged elapsed time of just four months. The bottom line – including settlement, as well as decisions – is that in all of the customer arbitration and mediation cases filed with NASD, almost seventy-five per cent result in compensation to investors.

Any claim that an investor believes he or she has against his or her broker or the broker's employer may be brought in the NASD arbitration forum. In 2002, the most widespread complaint was for breach of fiduciary duty. Other common complaints were unsuitable recommendations, failure to supervise and misrepresentation.

NASD also manages a mediation program, which is an informal, voluntary process in which an impartial person, trained in negotiation and facilitating settlements, helps parties reach a mutually acceptable resolution. Mediation is non-binding, and during the last seven years nearly eighty percent of NASD-managed mediation cases reached a settlement.

Conclusion

At NASD, we believe that, in addition to crafting tailored enforcement remedies and effective regulatory changes, an important part of restoring investor trust is to ensure and demonstrate very publicly that, where wrongdoing is uncovered and proven, significant fines will be collected and channeled to greater enforcement efforts, enhanced regulation and, through restitution, to investors. H.R. 2179 furthers the goals of maximizing restitution to investors and arming the SEC with additional tools to quickly and effectively combat securities law violations and we thank the Subcommittee for this to chance to testify in support of the bill.

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July 3, 2003

The Honorable Paul E. Kanjorski
2353 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Kanjorski:

Thank you for the opportunity to respond to your questions following the June 5, 2003 hearing regarding H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003. It was an honor for me to present testimony on behalf of the North American Securities Administrators Association and to express the concerns of state securities regulators regarding Section 8(b) of that legislation. We greatly appreciate your support and thoughtful comments during the Subcommittee hearing. I am providing the following responses to your recent questions.

1. How many parallel actions do state securities agencies and the Securities and Exchange Commission and/or federal criminal authorities bring on an annual basis? How many cases do the states bring in which there is not a parallel action by the Securities and Exchange Commission or another federal agency?

Many of the states' fiscal years ended on June 30, 2003 and we have not yet compiled all of the statistics for FY 2003. In anticipation of the end of the fiscal year, NASAA just sent a 2002/2003 enforcement survey to the membership and we'll have more current information within a few weeks.

I can convey that for the reportable year 2001 – 2002, state securities regulators filed 2, 579 administrative actions and 70 civil actions. In that same period, state securities regulators had a role in referring or assisting with the prosecution of 360 criminal actions. The overwhelming majority of those cases were filed independent of an action by the SEC or another federal agency. Responses to a question recently directed at our membership are consistent with those numbers.

You can be assured that there is considerable cooperation and coordination between state securities regulators and federal agencies. The states frequently work with the SEC, the U.S. Attorney, the Postal Service, the FBI and the CFTC on enforcement matters. We regularly assist each other by exchanging investigative resources, evidence and other case related information. That being said, such coordination most often results in only one regulator, either the state or federal, filing the enforcement action.

2. Of the total disgorgement payments and penalties annually ordered by state authorities from broker-dealers, approximately what portion goes toward investor restitution? What mechanisms do state authorities presently have available to identify harmed investors and distribute funds collected?

A primary and routine objective of state securities regulators is to obtain restitution for investors as part of enforcement actions. For example, in the 2001/2002 reporting period, state securities regulators collectively obtained orders for over $309 million in restitution. During the same period, roughly $71 million was ordered in civil and administrative fines and penalties. State securities enforcement cases often impose conduct remedies, fines or penalties *and* restitution to investors.

Fine and penalties monies are allocated according to the governing law in each jurisdiction. In most instances, fines and penalties are not allocated for restitution, but restitution is provided separate and apart from the punitive actions. In your jurisdiction, the primary objective in an enforcement action brought by the Pennsylvania Securities Commission (PSC) is restitution to investors. Where PSC is able to identify the injured investors, it often will forgo imposing penalties in order that all funds recovered will go to investor restitution. Where penalties are imposed by PSC, Pennsylvania law requires that such penalties be retained by PSC to support its enforcement, compliance and investor education programs.

As a specific example, during the past three years the Alabama Securities Commission has undertaken to return funds in a number of cases to defrauded investors. The following are three such cases as examples of restitution mechanisms.

Case one: Alabama Securities Commission vs. MN Partners, the Commission became aware of a scam involving internet sales of investments promising sky high returns for a minimal cash investment. The Commission instituted a court action in January of 2002 and obtained receivership authority shortly thereafter. Approximately 33,000 units (investments) had been sold. The Commission issued over seventeen thousand checks to investors (some had multiple units) returning approximately seventy percent of the original investment amount to harmed investors. The entire process from initial investigation to final disbursement took approximately fourteen months. The time from final order of receivership to disbursement took approximately ninety days.

Case two: In re: The International Benevolence Foundation and IBF Trust was a religious affinity scam that took in over 9500 individuals. ASC, under a federal court order completed the task of mailing approximately 9500 checks in August of 2002. Investigation on the case began in 1999 with a court referring authority to the Securities Commission for disposition of real estate and other assets for the benefit of investors in 2000. Although the foundation and its trust were closed in 1999 the matter was criminal in nature and required the completion of the criminal case as well as the sale of various pieces of real estate including hunting lands, which required a lengthy time to liquidate. Although the entire case took approximately three years the mailing of the checks and returns to investors from the time of final disposition of real estate and other assets was less than eight months. Further, determination of victims was difficult since records had to be recreated. IBF founder served time in federal prison.

Currently, the Alabama Securities Commission is undergoing a disposition of assets of WBI (Wealth Builders International) an options trading operation, which took investments from over 1700 individuals. The Commission has seized assets by its authority under state law and is awaiting final court approval for disposition. It's estimated that within sixty days after final order of the court that investors would receive their pro-rata share of WBI assets.

3. What effects do you believe that remitting penalty and disgorgements funds to the Securities and Exchange Commission for distribution will have on the speed and size of the restitution that investors receive as a result of state enforcement actions? Please provide any data that you may have on the scope or speed of investor restitution done at the state level.

I am very concerned that remitting penalties and disgorgement funds to the SEC for distribution back to investors as a consequence of a state enforcement action will result in a delay in the allocation of the monies. As a practical matter, considerable time may pass between the time a state remits its penalty monies, along with an investor victim list to the SEC, and the time when federal bureaucracy is able to process the claims and send money back to investors. The process surrounding the federal Distribution Fund of the Global Settlement may take between 18 and 24 months before funds are distributed to investors.

By contrast, most small, intrastate restitution cases can be administered directly by a state securities agency. A list of victims is often identified as part of the investigation and restitution made soon after the case is finalized. As stated in the above Alabama examples, investors received restitution in three to six months after the final order of the court.

Large restitution cases have also been handled successfully and efficiently by the states. The Arizona Corporation Commission conducted a full investigation into the activities and sales practices of The Baptist Foundation of Arizona (BFA). Baptist Foundation officials were indicted on 32 separate counts of fraud racketeering and theft. Three other individuals pled guilty to felony charges and agreed to cooperate with the State of Arizona.

Arthur Andersen and a law firm were sued by the Arizona Corporation Commission for aiding and abetting the BFA securities fraud. They settled in principle in May 2002. Final court approval (superior court and bankruptcy court) took place in September/October 2002. Final restitution distribution of $217 million to Baptist Foundation of Arizona investors took place in January 2003.

4. What types of remedial actions are commonly ordered by state authorities in connection with securities violations by broker-dealers? How often do state regulators enter into agreements that include remedial actions of the scope of those included in the Global Settlement?

State securities regulators are creative in crafting remedial requirements that address the particular violation committed by a broker-dealer. Often, enhanced supervision and compliance measures are imposed on the firm. These measures can include improved internal controls; requirements to call customers; expansion of the compliance department; requiring an independent audit with a report sent to the securities agency, amongst others. In extreme cases, individuals or firms can lose their license and ability to do business in a state.

A routine remedy for selling unsuitable investments would be to negotiate with the firms to return losses to investors and require the firm and/or the sales representative to address the underlying causes of the unsuitable investment. Those remedies often include having the branch manager review trades and compare them with the customer's investment objectives; requiring the representative to take specialized training; or requiring compliance or management procedures to anticipate problems.

These types of measures are not only protecting investors, but ultimately, sound business practices that benefit the firm in the long run.

State securities regulators rarely enter into global settlements that include remedial requirements of the size and scope of the global case. The analyst settlement was atypical of the cases undertaken by state securities regulators.

5. The North American Securities Administrators Association has expressed concern that H.R. 2179 would inhibit states in the future from using some types of remedial actions that they now commonly seek. More specifically, these concerns have focused on Section 8(b). This provision is triggered when the states impose "any requirements for broker dealers . . . relating to capital, custody, margin, financial responsibility, record-keeping, bonding or financial or operational reporting or disclosure that differ from or are in addition to the requirements in those areas under the securities laws . . ." Would you describe the specific types of commonly ordered remedial actions that you believe would trigger the provisions of Section 8(b)?

Our interpretation of the statutory language in Section 8(b) is that the conduct remedies described in our answer to question 4 would trigger the Section 8(b) mechanism.

6. The North American Securities Administrators Association has suggested that states routinely seek restitution in enforcement actions. Why did state securities regulators opt against pursing restitution as part of the Global Settlement?

Throughout the eighteen months of the analysts' investigations, state securities regulators wrestled with how best to compensate investors injured by the wrongdoing. Restitution is a viable remedy where victims can be readily identified, where the fraud is direct and person-to-person and where damages are subject to straightforward calculation. In order to satisfy the expectations of the victims, there also needs to be enough money to distribute through restitution so that the recipients receive a sum that represents a meaningful portion of their losses. Unfortunately, we do not believe the analyst cases readily lend themselves to restitution.

One of the reasons we have struggled is because it is very difficult to identify the victims of any fraud perpetrated on the market as a whole. We could start with the customers who purchased the stocks through the firms, but what about those who saw Henry Blodget on CNBC and then purchased the stocks online or bought stocks from a firm that purchased research from one of the ten firms? And what about mutual fund shareholders? Some of those investors may not even have known they owned shares in the stocks in question.

In our view, in a fraud on the market, *all* investors are harmed. If restitution were available to all investors, it would be an insignificant amount of their losses. If restitution is available to only a subset of investors, it is arbitrary and unfair. In light of these problems, we believe decisions regarding the use of funds are best made at the state level so they can be tailored to the unique circumstances of each state.

7. There has been much discussion about the distribution of penalty monies from the Merrill Lynch settlement. Please explain the distinction between the Merrill Lynch agreement and the Wall Street Global Settlement.

New York Attorney General Eliot Spitzer initiated an investigation into Merrill Lynch's analyst research and investment banking businesses. Last spring, as the Attorney General's office was wrapping up its Merrill Lynch investigation, NASAA suggested to Attorney General Spitzer that it would be beneficial to all concerned to settle the case simultaneously for all the states as a group. He agreed, and negotiated on those terms. The NY Attorney General's office spent its resources and staff time to initiate and complete the Merrill Lynch case. New York received \$48 million, \$50 million was divided amongst the rest of the settling entities based on a population formula with a minimum payment of \$500,000, and NASAA received \$2 million, which funded the ongoing investigations. The case was concluded with all 50 states and the District of Columbia and Puerto Rico joining in the settlement.[1]

In late April, a few weeks before the Merrill Lynch agreement, the NASAA Board of Directors met to form the NASAA Analysts Task Force. Its Steering Committee was charged with investigating whether problems discovered at Merrill Lynch were industry wide. The Steering Committee assigned one state to lead the investigation of each firm; many other states signed on to assist in the investigations. Further, the

[1] See NASAA Analyst Investigations Chronology Attached

Task Force agreed to work collaboratively on the analyst investigation with the SEC, the NYSE and the NASD.

The state investigations continued into November, at which time, in conjunction with the SEC, NYSE and the NASD a determination was made to pursue the resolution of the cases in a global manner. Each firm investigation included a lead state and a federal counterpart. Last December, an agreement in principle was reached with 11 firms; it took intensive negotiations with the firms to reach the final global settlement.

In contrast to the Merrill Lynch case, in the analyst cases, the SEC, the NYSE, the NASD, the states, and the New York Attorney General were equals in the negotiating process and it was determined that any fines, penalties or other remedies would be divided equitably. The states are to receive their share of the total monetary sanction, which will be distributed to the signing states on a population-based formula.

8. Please anticipate the effects on the budgets of state securities enforcement offices if the Congress adopted Section 8(b) in its present form.

It's extremely difficult to anticipate the effect of Section 8(b) on the budgets of state securities enforcement offices. I do know that states play a vital role in the audit/exam process, often citing deficiencies that, left uncorrected, might result in investor losses. In Illinois, the entire audit and enforcement staff is paid out of the dedicated "Audit and Enforcement Fund." Any penalty money diverted to the FAIR fund that would otherwise be deposited into this Illinois dedicated account would certainly diminish the State's ability to audit financial firms' compliance with legal requirements.

In general, state securities agencies are a part of governmental bodies where there are performance-based evaluations. I'm very concerned that state funding for the agency will be endangered if a state securities agency is spending resources on an investigation and pursuing an enforcement case while the penalty monies resulting from the case are removed from the state and sent to Washington for distribution.

Thank you again for giving me a chance to elaborate on some of the issues raised during the June 5 hearing. Please do not hesitate to contact me if there is additional information that may be of assistance to you.

Sincerely,

Christine A. Bruenn

Christine A. Bruenn
NASAA President
Maine Securities Administrator

NASAA Analyst Investigations Chronology

Date	Event
7/2001	NYAG starts probe into ML.
4/12/2002*	Spitzer sends subpoenas to 12 investment banks with significant research and investment banking revenues requesting that they supply documents that will address analyst's roles in investment banking. (*Not all subpoenas sent out on same date).
4/18/2002	NASAA files letter with SEC in response to SRO's proposed rules addressing analyst conflicts of interest. NASAA suggests that while the rules are a good start, they need to be more expansive.
4/18/2002	NASAA Board of Directors meets to form NASAA Analysts Task Force to be charged with investigating whether problems discovered at Merrill Lynch are industry wide.
4/25/2002	NASAA/SEC/NASD/NYSE agree to work collaboratively on analyst investigation.
4/26/2002	NASAA Analyst Task Force assigns a lead state to investigate each target firm identified by the NYAG in its subpoenas and asks other states to volunteer to assist in the investigation under the management of the lead state.
5/14/2002	NASAA Board approves $2.5 million budget for analyst investigation.
5/21/2002	NYAG settles with ML to agree to terms of settlement. Settlement contains proposed settlement provisions with other states.
6/18/2002	NASAA Board endorses sending settlements to all the states.
6/20/2002	NASAA sends states template to be used in ML settlement.
9/20/2002	NASAA signs contract with Case Central, an electronic discovery company, to assist the states in search, organizing and sharing discovery documents.
10/03/2002	NASAA/SEC/NYAG/NASD/NYSE agree to work together in an attempt to conclude the investigations in a speedy fashion.

12/20/2002	Tentative settlement agreement reached among almost all target firms among states, SEC, NASD, NYSE for 1.4 billion in fines and other payments.
03/10/2003	NASAA submits comment letter to SEC in response to SRO's amendments to rules filed in 2002 noting that the SROs for picked up most of NASAA's suggestions from its 4/18/2002 letter.
4/28/2003	Reach Final Agreement. among almost all target firms, lead states, SEC, NYSE and NASD.