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## Testimony Before the Senate Committee on Financial Institutions and Insurance

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I am pleased to be here today to discuss the important work the Office of the Securities Commissioner is doing to protect investors. Financial fraud against our citizens is a topic that our agency cares about deeply.

In inviting me here today you have asked that I discuss SB349, and how it can improve capital formation, economic development, and more effective enforcement of our securities laws.

Protecting investors is one of the most important issues of our time. Given the news topics we see every day in the papers and on the internet, it would be simple for me to come before you today and echo the common refrain of the Wall Street v. Main Street disparity, or to make a broad case for investment oversight and investor protection.

However, I think a more useful explanation of the importance of our bill is to highlight the true magnitude of the new responsibilities that our agency faces both in the immediate term and in the future.

Presently there are 40 million Americans age 65 and older. In my lifetime that figure will double, representing an impressive 20% of the total projected population. Longevity is now the norm in our country, and for that we can all be grateful — but it also presents new issues that our agency must prepare for. Every year, as medical miracles allow us to enjoy a larger population of senior citizens, the task of protecting investment saving grows in importance.

In the 21st century, Americans will live significantly longer than their parents — and longer than most of them planned for their retirement. A number of older Americans will face difficulties in making their retirement assets last an extra decade or more.

It is estimated that Americans 65 and older hold \$10 trillion in assets. Yet nearly a third of that group claims they do not have enough money even to meet their basic living expenses. Those with sufficient funds to invest may be tempted to take higher risks with their investments in order to achieve higher returns, instead of switching into low-yield, safe investments like the retirees of yesteryear. That will make them prime targets for scam artists and unscrupulous financial advisors.

According to the Federal Reserve Bank, households led by people over 40 already own over 90 percent of America's net worth, and Americans aged 55 to 64 have the highest income and the highest net worth of any age group.

As the baby boomers continue to age, it will be a very short time before the vast majority of the nation's savings are in the hands of America's elderly. I can promise you that the individuals who have their own financial interests in mind know this fact as well. By 2018, the number of personal financial advisors is expected to increase by more than 60,000, a 30% growth from 2008. This rate is significantly more than the national average job growth rate.

We have long known that the elderly are especially vulnerable to the financially devastating impact of frauds and scams. However, our agency recognizes that the targets of securities fraud are no longer limited to the proverbial elderly widow. In fact, contrary to popular belief, relatively savvy investors are the most likely victims of financial fraud.

A comprehensive study commissioned by the financial services industry with the assistance of AARP found that victims of financial fraud tend to be male, college-educated and married. Most have higher income than the average population.

Securities fraud is of high concern because 90% of our country's net worth is in households led by people 40 and older. It's never good to be a victim, but for older people, there is no second chance.

Our citizens have worked hard to build both our state's economic prosperity and lifetime's worth of savings. As regulators, we must do all we can to ensure that their golden years are not tarnished by investment fraud. While our cases of investment fraud may not make national headlines, they are devastating in their impact to the victims and their families.

Investment fraud has existed in Kansas for over 100 years; it is a serious ongoing problem and we fear that it will only grow without targeted enforcement and enhanced investor education. The most effective weapon against investment fraud is a one-two punch of aggressive enforcement efforts combined with financial education to protect investors from unscrupulous individuals. Our agency needs all of the tools available to stop investment scams aimed at our citizens.

### **Securities Litigation Fund**

Through the years, states have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious jail time for securities-related crimes. We have successfully exposed and addressed the profound conflicts of interest among Wall Street stock analysts by requiring changed behavior. We led all regulators on late trading and market timing in mutual funds. We address on daily basis abusive sales practices targeting citizens from all walks of life. In the last few years, state securities regulators have been at the forefront of investor protection. Our record demonstrates clearly that we have the will and ability to regulate.

While my colleagues and I currently see a proliferation of troubling schemes involving unlicensed individuals promoting and selling unregistered securities in our state, we are also concerned about the way in which otherwise legitimate securities are marketed and sold by licensed financial advisors.

Our agency, along with other government agencies and self-regulatory organizations has seen an increase in the sale of complex securities. With the increase in the marketing and sale of these products, a corresponding increase in compliance deficiencies and investor complaints has occurred as well.

A complex security does not bear that title by accident or convenience. These products include an investment strategy with novel, complicated or intricate derivative-like features, such as structured notes, inverse or leveraged exchange-traded funds, hedge funds and securitized products, such as asset-backed securities. These features may make it difficult for a retail investor to understand the essential characteristics of the product and its risks, including the possibility that the product will not perform as many investors anticipate, or that it might be inappropriately sold on the basis of enhanced yield, principal protection or the tracking of an index or a reference asset. In many cases, our office has examined established firms that have no written procedures for vetting these products or supervising the sale and marketing of the products to retail investors.

Our office has expressed concern about complex products to many of the firms and individuals we regulate and have devoted more resources to the issues presented by complex products. However, we continue to witness these deficiencies, which result in investigations and prosecutions of conduct such as the misrepresentation of these investments as appropriate for retail investors seeking safety, fraud in collateralized debt obligation marketing materials, and misrepresentations about the extent to which an investment exposes the owner to the subprime real estate market.

While these complex securities may be legitimate and suitable investments for some, unfortunately these products are unsuitable for many and are being aggressively pitched to older investors.

Other trends we are seeing include a rise in energy and precious metals scams, and fraudulent offerings of investments tied to natural gas, wind and solar energy and the development of new energy-efficient technologies.

As matters pertain to criminal enforcement, state securities regulators have the determination, willpower and experience to pursue perpetrators of financial crime. We have learned how to accomplish more with less. However, there is little doubt that additional resources would enhance our ability to uncover and prosecute securities fraud during this economic downturn, which has resulted in vulnerable investors looking to recover their losses.

All of the attorneys in our agency have been deputized to serve as special assistant attorneys general to prosecute or assist in the prosecution of criminal violations on behalf of the state. Deputizing a state securities attorney gives a county prosecutor or district attorney the ability to formally utilize the expertise of our attorneys in prosecuting complex securities cases. This is a valuable leveraging of talent and resources and should continue to be encouraged.

Prosecuting securities fraud is not a simple task, nor is it inexpensive. When our office pursues a criminal violation of our securities act, it is coordinated with the district attorney in the county where the crime took place. While our attorneys serve as first-chair prosecutors and assume responsibility for all aspects of the case, it is the county that bears the cost of the prosecution. Only a few counties in Kansas have the budget necessary to warrant a full-scale securities fraud prosecution; even then it can be a significant and unplanned drain on their resources. It is a likely scenario that when we uncover a fraud in a smaller, less-populated county, that the costs of prosecution could be greater than a county's prosecution budget for the entire year. Gone are the days where our cases can be pursued as simple theft-by-deception crimes. The matters that cross my desk today demand the resources to explain derivatives trading to a jury, forensic

accounting reports, and in an increasing number of matters in western Kansas, the hiring of Spanish-speaking translators.

By authorizing this securities litigation fund, our enforcement and legal staff can be self-sufficient and more nimble, which will improve our effectiveness.

### **Securities Restitution Fund**

In many cases private litigation is the best tool for the enforcement of laws. It is the democratization of the enforcement process. It allows parties to pursue peaceful redress for themselves without burdening limited public resources to do it for them.

Since public enforcement cannot handle all the needs of aggrieved parties, private litigation is the only practical mechanism for people to right civil wrongs. Private enforcement provides the protection of the rule of law available to all citizens. Ineffective private enforcement undermines the confidence of participants in the marketplace of commercial and interpersonal interactions, whether the market be securities investing, employment, used cars, intellectual property, or myriad other areas of human commerce.

Like all tools, however, private enforcement has limitations. Our intention for implementing an investor restitution fund addresses another important limitation on public and private enforcement: a judgment or award against a party is meaningless if the losing party cannot pay. The justice that Kansas investors seek can be achieved only if they are able to recover the money they lost.

There is, of course, no general guarantee in the civil justice system that all defendants will be solvent. Nor is there a general guarantee that a defendant who is solvent at the outset will remain so through the litigation. Additionally, investors usually have limited options for keeping a respondent from dissipating assets during the pendency of a claim.

But regulated activities are special, and general rules of the marketplace do not apply to the financial responsibility of regulated actors toward their clients. For example, national banks must comply with reserve requirements and are required to purchase FDIC insurance for their depositors. All interstate truckers must meet federal financial responsibility requirements, including obtaining liability insurance. Doctors in some states are required to carry malpractice insurance. Similarly, errors and omissions insurance is typically mandatory for all real estate salespersons and brokers as a condition of licensure.

No comparable requirements exist for firms and individuals who sell securities. There is no question that the securities industry is supposed to be a highly regulated activity. Nonetheless, many financial advisors risk people's life savings while operating without adequate capital or liability insurance.

Investors are shocked when they discover that the people they entrusted with their irreplaceable assets have no money to repay them when found guilty. They are shocked to learn that companies in a supposedly highly regulated industry are permitted to manage tens or even hundreds of millions of dollars for the public without any insurance or financial backing.

Part of our regulatory responsibility is assuring the financial responsibility of members in all contexts, including dispute resolution. The whole point of trusting someone with your finances is lost if the industry does not assure that its members are themselves financially responsible and that, if you prevail in a dispute asserting wrongdoing on their part, your award will be paid.

Those who wish to manage the financial security of others must demonstrate financial responsibility. If the industry does not protect public consumers, it fails its duty of self-regulation. The current scheme that allows companies to invite trust and then walk away without paying for the consequences of their misconduct is indefensible.

Undercapitalized broker-dealers are disproportionately represented in wrongdoing leading to customer claims. This unsurprising fact has been known for a long time. The SEC identified the same problem in its special report to Congress in 1963, finding that broker-dealers operating with limited capital committed a "disproportionate number" of SEC rule violations. More than forty years later, the problem still has not been meaningfully addressed.

Allowing judgments and awards to remain unpaid has the potential to undermine investor confidence and is, in any case, a blemish on the reputation of the U.S. capital markets. In view of this reality, it is clear that state regulators should impose discipline from outside.

An investor restitution fund funded like the FDIC by industry contributions would substantially minimize the problem of unpaid awards.

The sad truth is that by the time one of our citizens realizes that they are the victim of a scam or outright financial theft, the wrongdoer has left, or has spent the money. This is often the case after our office has been notified and begins enforcement proceedings. This results in an individual that not only has no money, but no trust in the system. Our bill would provide a limited source of funds for citizens in this situation.

One of the byproducts of our successful criminal prosecutions is that in most cases, when we pursue formal sentencing in a case, it is because there is no money left. For all practical purposes, once a defendant is behind bars, the likelihood of money being recovered or paid back to victims is unlikely.

It is true that investing does have risks. However, in many cases investors come to our office seeking assistance regarding an investment that simply never existed, or because the wrongdoer simply stole the money, or forged the client's name.

By creating a restitution fund, our aim would be to put money back in the hands of innocent victims; this could be the difference between a widow being able to keep her house, or to pay for medical expenses, rather than request public assistance from the social services our state offers.

I thank the Chairman and each member of this committee for allowing me the opportunity to appear today and for considering our recommendations to enhance our ability to pursue financial fraud and prosecute the perpetrators of those crimes. I look forward to answering any questions you have and providing additional assistance to you in the future.