Final Report:

2003 Conference on Federal-State Securities Regulation

U.S. Securities and Exchange Commission
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Table of Contents

I. Summary

The United States Securities and Exchange Commission (the "SEC" or "Commission") and the North American Securities Administrators Association, Inc. ("NASAA") held their annual conference in Washington, D.C. on April 7, 2003. The 2003 meeting was the 19th annual conference held under Section 19(d) of the Securities Act of 1933.[1] That provision requires an annual conference to promote the following goals:

- maximizing uniformity in federal and state securities regulation;
- maximizing the effectiveness of such regulation;
- reducing the costs and paperwork of raising investment capital; and
- minimizing interference with capital formation.

The SEC and NASAA issued a joint release[2] before the meeting announcing the proposed agenda and seeking comments from interested members of the public concerning the proposed topics as well as other relevant matters.[3]

Approximately 200 representatives from the states and the SEC attended the 2003 meeting.[4] The participants divided into five working groups in the subject areas of corporation finance, investment management, market regulation, enforcement, and investor education and assistance to discuss matters of common interest. Part II of this report describes the discussions of each group. During the group meetings, the participants outlined current state and federal regulatory efforts and initiatives. They also identified areas where joint cooperation would be beneficial and discussed ideas and plans for more effective cooperation, coordination and communication.

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[1] Formerly Section 19(c) of the Act. The provision was renumbered by section 108 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

[2] Securities Act Release No. 8207 (Mar. 17, 2003) [67 FR 14439].

[3] Comment letters are available for public viewing in File No. S7-05-03 in the Commission's Public Reference Room at 450 5th St., N.W., Washington, D.C. 20549, and on its website at www.sec.gov.

[4] Conference participants are listed in Part III of this report.

II. Reports of the Working Groups

A. Corporation Finance

The corporation finance working group included members of the Commission's staff from the Division of Corporation Finance and state representatives. A summary of the group's discussions follows:

1. Sarbanes-Oxley and Related Rulemaking Initiatives

The Commission staff summarized their most recent rulemaking initiatives, most of which were mandated by the Sarbanes-Oxley Act.[5] The summary included final and proposed rules governing: (1) ownership reports and trading by officers, directors, and principal security holders;[6] (2) certification of disclosure in company quarterly and annual reports;[7] (3) conditions for use of non-GAAP financial measures;[8] (4) insider trading during pension blackout periods;[9] (5) disclosure requirements concerning company audit committee financial experts and codes of ethics;[10] (6) disclosure in management's discussion and analysis ("MD&A") about off-balance sheet arrangements and aggregate contractual obligations;[11] (7) auditor independence;[12] (8) standards of professional conduct for attorneys;[13] (9) acceleration of filing deadlines for periodic reports and disclosure of website access;[14] (10) Form 8-K disclosure and acceleration of filing requirements;[15] and (11) disclosure of critical accounting policies.[16]

Commission staff discussed the impact of Sarbanes-Oxley on small companies. They noted that small companies may be less inclined to pursue a public offering or voluntarily register as public companies, given the increased cost of compliance with

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[5] Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

[6] *See* Exchange Act Release No. 46421 (Aug. 27, 2002) [67 FR 56462].

[7] *See* Securities Act Release No. 8124 (Aug. 28, 2002) [67 FR 57276].

[8] *See* Securities Act Release No. 8176 (Jan. 22, 2003) [68 FR 4820].

[9] *See* Exchange Act Release No. 47225 (Jan. 22, 2003) [68 FR 4338].

[10] *See* Securities Act Release No. 8177 (Jan. 23, 2003) [68 FR 5110].

[11] *See* Securities Act Release No. 8182 (Jan. 28, 2003) [68 FR 5982].

[12] *See* Securities Act Release No. 8183 (Jan. 28, 2003) [68 FR 6006].

[13] *See* Securities Act Release No. 8185 (Jan. 28, 2003) [68 FR 6296].

[14] This release was not mandated by the Sarbanes-Oxley legislation. *See* Securities Act Release No. 8128 (Sept. 5, 2002) [67 FR 58480].

[15] *See* Securities Act Release No. 8106 (June 7, 2002) [67 FR 42914].

[16] *See* Securities Act Release No. 8098 (May 10, 2002) [67 FR 35620].

the new rules. Also, compliance with the new rules might prove too burdensome for currently reporting smaller companies in light of limited resources. With regard to the rules requiring the disclosure of whether a company has a financial expert serving on its audit committee, state representatives reported that small companies complain that the new financial expert standard is an added burden to an already difficult process in locating audit committee members. Commission staff responded that accommodations were made for small business issuers in that their new disclosure obligations sometimes take effect for the fiscal year ending after December 2003, instead of July 2003, as is the case for other issuers. However, given these concerns, Commission staff noted that there was a need to monitor and assess the impact of the new rules on the small business community, while being cognizant of the necessity to achieve an effective financial reporting and disclosure system for the investing public. With these objectives, the Commission staff noted that it will continue to review the situation.

The Commission staff noted that the purpose of adopting rules requiring a discussion of off-balance sheet arrangements in the MD&A was to strengthen the MD&A disclosure. The Commission staff mentioned that the improved disclosure may cause the MD&A to be so lengthy that a summary may be required. However, in light of the recent review of the annual reports filed by the Fortune 500 companies, improvements to the MD&A section are warranted. In that review, the Division of Corporation Finance issued over 400 comment letters. A majority of those comment letters focused on MD&A disclosure. State representatives asked if any enforcement referrals originated from the review. The Commission staff responded that, while the review did result in enforcement referrals, this was not the Division's aim. The Commission staff added that the main objective of the review was to improve the quality of disclosure. A report of the review can be obtained from the Commission's website. Commission staff stated that the report is an indicator of the focus of future Commission staff reviews.

2. Operations and Processing

Commission staff discussed the increasing number of filings by what appear to be blank check companies. They explained that these companies attempt to avoid compliance with Rule 419 of Regulation C[17] by disclosing in their Form SB-2 filings that they have a business plan. Although a company with a real business plan is not a blank check company, these companies have no assets, management experience or operating history with which to implement their business plans. During the comment process, the staff may ask these companies to distinguish themselves from blank check companies. Commission staff wanted to know whether these types of filings were being monitored by the states. A state representative explained that blank check companies generally do not qualify for coordinated review. The few that do qualify eventually drop out of the registration process.

[17] Under Commission Rule 419, a blank check company is defined as a development stage company with no specific business plan or purpose, or a company that indicates that its business plan primarily involves merging or acquiring an unidentified company or companies. The Commission has adopted several rules to deter fraud in connection with offerings by blank check companies. *See* 17 CFR 230.419 and 17 CFR 240.15g-8.

3. Office of Small Business Policy Rulemaking and Other Initiatives

a. Definition of "Qualified Purchaser"

On December 19, 2001, the Commission approved a release proposing to define the term "qualified purchaser."[18] As proposed, "qualified purchaser" would have the same meaning as the term "accredited investor" in Rule 501 of Regulation D.[19] Offerings made to "qualified purchasers" would be deemed offerings of "covered securities" pursuant to the National Securities Markets Improvement Act of 1996. Transactions involving covered securities are preempted from state registration and review. Commission staff provided a general overview of the proposed definition, and related issues concerning the treatment of Rule 504 offerings. They reported that the Commission staff is considering the views expressed in the comment letters in determining what approach they should recommend that the Commission take in the adopting phase.

b. Regulation A

Regulation A provides an exemption from the registration requirements of the 1933 Act for certain non-reporting issuers. Regulation A offerings may not exceed $5 million within a 12-month period, and the securities are freely tradable. Issuers may also "test the waters" to determine whether an offering will attract the investing public before assuming the full cost associated with an offering. Because the exemption appears to be underutilized, Commission staff discussed possible revisions to Regulation A for purposes of making the exemption more appealing to small businesses. Those revisions might include raising the ceiling from $5 million to $20 million, requiring two years of audited financial statements for any offering above $5 million, and eliminating Models A & B from Form 1-A, the form used for Regulation A filings, and using the disclosure requirements of Part I of Form SB-2 instead. In connection with the possible revisions to Regulation A and Form 1-A, the Commission staff noted that it was also considering recommending the repeal of Form SB-1.

c. Form D

Issuers claiming one of the limited offering exemptions under Regulation D are required to file a Form D with the Commission within 15 days after the first sale.[20] Participants reported the continuing efforts of a working group, consisting of NASAA members and Commission staff, to replace paper filings of Form D with electronic submissions through the Commission's EDGAR system. Commission staff reported that the Form D is being surveyed to identify items that are necessary, and those that can be eliminated for purposes of simplification. In assessing the needs of the new Form D, Commission staff expressed an interest in including additional areas for notes, similar to Forms 3, 4, and 5.

[18] Securities Act Release No. 8041 (Dec. 19, 2001) [66 FR 66839].

[19] 17 CFR 230.501.

[20] 17 CFR 230.503.

d. Rule 701

Under certain conditions, Rule 701 allows issuers to offer securities to employees pursuant to a written compensatory plan or contract without registering the offering under the 1933 Act. Commission staff receive many telephone queries concerning Rule 701 transactions. To assist the public, Commission staff noted that it is contemplating the preparation of a telephone interpretation manual dedicated to Rule 701. The telephone interpretation manual would be available on the Commission's website.

e. Blank Check Companies

Participants discussed possible rule revisions aimed at improving the timeliness of certain disclosures made by blank check companies. Currently, blank check companies that have made a significant acquisition may take up to 75 days to file financial information on Form 8-K. Commission staff discussed the possibility of requiring blank check companies to file the Form 8-K within 15 days after making a significant acquisition.

4. Joint Session with the Division of Investment Management on Hedge Funds

The corporation finance working group met with the investment management working group to discuss current issues involving hedge funds. It was noted that the hedge fund industry has grown considerably in the last decade, with approximately 5,700 hedge funds operating in the U.S., with an estimated $600 billion in assets. A representative from the Division of Investment Management reported a substantial increase in fraud cases involving hedge funds within the last two years, and increased pension fund exposure to hedge fund risk.[21] The IM representative stated that the ongoing concerns involving fraud, conflicts of interest, and a lack of risk transparency led the staff from the Division of Investment Management and the Office of Compliance, Inspections and Examinations ("OCIE") to conduct a review of the operations and practices of hedge funds. The review commenced in June, 2002, and will include a roundtable discussion hosted by the Commission and scheduled for May 14th and 15th, 2003.

Participants discussed the problems surrounding the use of the Rule 506 exemption as a vehicle for hedge funds. Specifically, a state representative mentioned that hedge funds do not adhere to the conditions of the exemption, as advertising and general solicitations are frequently used to promote hedge funds. Given NSMIA's preemption of state review for Rule 506 offerings, disclosure deficiencies were also cited as a concern.

[21] Although many hedge fund advisors are not required to register with the Commission, they are subject to the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6.

B. Investment Management

The investment management working group included representatives from the states and the Commission's Division of Investment Management ("IM") and Office of Compliance Inspections and Examinations. A summary of the group's discussions follows:

1. Current Issues and Rulemaking

IM representatives outlined a number of new rules adopted or proposed in the last year to enhance investor protection and update the regulatory requirements for SEC-registered advisers. An IM representative outlined the provisions of the new proxy voting disclosure rule.[22] The group also held an extensive discussion of the Commission's proposed rule on adviser custody requirements[23] and the proposed rule on compliance programs for advisers.[24] An IM representative announced that the Department of Treasury is expected to propose regulations under the USA Patriot Act[25] in the near future that will extend anti-money laundering provisions to SEC-registered advisers. It was announced that state representatives will be meeting with representatives from the Department of Treasury soon to discuss the status of state registered advisers under the USA Patriot Act. Representatives from the states and IM also discussed how they could more effectively coordinate on the development of rules affecting their respective adviser populations.

2. Examination Issues

A representative from OCIE reviewed the 2002 program of examinations conducted in the state of Wyoming, which has no state adviser regulation authority. There was a discussion about specific steps that could be taken to enhance information exchanged between state regulators and OCIE when an examination indicates that an adviser must change its state or federal registration status. A representative from IM reviewed key enforcement actions taken by the Commission against advisers for a wide range of securities law violations, including misappropriation, market manipulation, insider trading, and false advertising.

3. Electronic Filing, IARD and Investment Adviser Public Disclosure

A representative from IM provided overview information on the current use of electronic filing on Investment Advisor Registration Depository ("IARD") by SEC registered investment advisers and state registered investment advisers. Currently, a combined total of over 15,000 advisers (SEC-registered and/or state registered) make filings electronically through IARD. A state representative reported that most states have mandated that state registered advisers must make electronic filings

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[22] *See* Investment Adviser Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585].

[23] *See* Investment Adviser Act Release No. 2044 (July 18, 2002) [67 FR 48579].

[24] *See* Investment Company Act Release No. 25925, Investment Adviser Act Release No. 2107 (Feb. 5, 2003) [68 FR 7038].

[25] 31 U.S.C. 5311 *et seq*.

with the appropriate state securities regulatory authority. Only a few states are still in the process of adopting legislation to require electronic filing by their advisers. During 2002, approximately 120,000 adviser representatives also began making Form U-4 filings electronically on IARD. IARD continues to operate smoothly with the increased filing volume. Representatives from IM and the states discussed both financial and operational issues related to future development of IARD. Because IARD is now operating in the black, Commission and state representatives agreed that funds are available to begin developing Part 2 of Form ADV in electronic format on IARD.

A representative of IM reported that there were over 31 million electronic inquiries on the Investor Adviser Public Disclosure system (IAPD). Participants discussed issues related to bringing profile information of adviser reps onto the IAPD. Participants also discussed the need to make information available on IAPD about those cases where an adviser applicant is denied registration with the Commission or with a state due to disciplinary problems. The participants agreed that displaying this information would benefit persons seeking background information about advisers from IAPD.

C. Market Regulation

State representatives and staff of the Commission's Division of Market Regulation and Office of Compliance Inspections and Examinations discussed the following matters:

1. Description of Bank Dealer Exceptions After the Gramm-Leach-Bliley Act

Commission staff reported that the Commission adopted amendments to the bank dealer rules on February 6, 2003.[26] These rules implement the specific exceptions for banks from the definition of "dealer" that were enacted as a part of the Gramm-Leach-Bliley Act ("GLBA")[27] in late 1999. Among other things, the GLBA provided for functional regulation of securities activities by eliminating the complete exception for banks from the definitions of "broker" and "dealer" and replacing them with specific transaction and activity-based exceptions. The new rules also provide banks with a new exemption for their securities lending transactions. The compliance date for the new dealer rules will be October 1, 2003. Beginning on that date, banks will have to comply with the more limited GLBA bank dealer exceptions and exemptions. The participants discussed the rules pertaining to banks' dealer activities.

2. Possible Revisions to Form BD

Under the regulatory scheme of the Securities Exchange Act of 1934[28] (the "Exchange Act"), broker-dealers must register with the Commission, as well as with at least one statutory SRO. Broker-dealers apply for registration by filing Form BD, the uniform application for broker-dealer registration. The state securities regulators also use this form. Form BD requires the applicant filing the form to provide certain information concerning the nature of its business and the background of its principals, controlling

[26] Exchange Act Release No. 47364 (Feb. 14, 2003) [68 FR 8686].

[27] Pub. L. 106-102, 113 Stat. 1338 (1999).

[28] 15 U.S.C. 78a *et seq*.

persons, and employees. Form BD is designed to permit regulators to determine whether the applicant meets the statutory requirements to engage in the securities business.

The Commission amended Form BD on July 2, 1999 to support electronic filing in the Internet-based Central Registration Depository system.[29] Since the July 1999 amendments, the GLBA, the Commodity Futures Modernization Act of 2000, and, more recently, the Sarbanes-Oxley Act have all been enacted. Among other things, the Sarbanes-Oxley Act expands the definition of "statutory disqualification" under the Exchange Act.[30] The group discussed these and other developments that may indicate the need for possible further amendments to Form BD.

3. Research Analyst Conflicts of Interest

We reported that a number of actions in the past year have been taken to address securities analyst conflicts of interest. The Commission adopted Regulation Analyst Certification, which requires that analysts certify that the views expressed in research reports and public appearances accurately reflect their personal views and whether analysts received compensation for their recommendations or views.[31] The Commission also approved rule changes by the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") that establish standards governing broker-dealer communications with the public to address analyst conflicts of interest.[32]

Late last year, the Commission released for comment additional rule amendments filed by the NYSE and NASD that would require a compensation committee to review and approve analyst compensation; prohibit firms from issuing reports by a research analyst who participated in solicitation meetings with prospective investment-banking clients; require notification to customers when a member or member organization terminates research coverage of a subject company and require that the final report include a final recommendation or rating; and amend the definition of "public appearance" to include research analysts' making a recommendation in a newspaper article or similar public medium.

The Commission staff worked with NASAA and its members, as well as the NYSE, NASD, and New York State Attorney General, on a joint formal inquiry into market practices concerning research analysts and the conflicts that can arise from the relationships between research and investment banking. On April 28, 2003, these regulators announced that enforcement actions against ten of the nation's top investment firms have been completed, thereby finalizing the global settlement in principle reached and announced by the regulators last December.[33]

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[29] Exchange Act Release No. 41594 (July 2, 1999) [64 FR 37586].

[30] 15 U.S.C. 78c(39).

[31] Securities Act Release No. 8193 (Feb. 20, 2003) [68 FR 9482].

[32] Exchange Act Release No. 45908 (May 10, 2002) [67 FR 34968].

[33] SEC Press Release 2003-54 (Apr. 28, 2003).

4. Shorter Settlement Cycles, Straight-Through Processing, and Immobilization and Dematerialization of Stock Certificates

Over the past year, the securities industry has undertaken an initiative to achieve several straight-through processing goals. In order to reach these goals, the industry, through the Securities Industry Association ("SIA"), has proposed that the Commission adopt a number of regulatory changes. One of the more controversial of the proposed changes is adding rules to discourage the issuance and use of physical certificates and encourage issuance of securities in book entry only format. The participants discussed how these goals might further be served by amending state corporate laws.

5. IPO Underwriting and Allocation Process

The initial public offering underwriting process has come under a lot of scrutiny lately—especially with regard to perceived abuses in the pricing and allocation of IPO shares. The Commission staff reported that it is currently reviewing industry practices regarding the roles of issuers and underwriters in the price setting and the allocation of IPO shares as well as the offering process in general. Moreover, the NYSE and NASD have convened a panel of business and academic leaders to conduct a broad review of the IPO process and to recommend ways to address the problems so as to improve the underwriting process and restore investor confidence. The Commission, so far, has also brought one enforcement action, the Robertson Stephens case, relating to underwriting activities in connection with a number of IPOs.[34] In addition, the NASD recently sought comment from its members on proposed new rules regarding the regulation of IPO allocations and distributions.[35] According to the NASD, the rules will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs.

6. Possible Changes to SRO Rules

a. Branch Office Definition

The NYSE filed with the Commission a proposed rule change, SR-NYSE-2002-34, which proposes to amend NYSE Rule 342, Offices – Approval, Supervision, and Control, to provide for a new definition of the term "branch office." The proposed amendment to the rule would limit the requirement to register certain business locations as "branch offices" to account for advances in technology used to conduct and monitor business and changes in the structure of broker-dealers and in the lifestyles and work habits of broker-dealers. On December 4, 2002, the Commission published the proposed rule change for public comment with the expectation that the NASD would be filing a substantially similar rule proposal concerning the NASD's "branch office" definition. The NASD has not yet filed a substantially similar definition. Given the negative comments that have been received on the NYSE filing, as well as possible further amendments to Form BD, and in particular Schedule E, the Commission is continuing discussions with the SROs as well as NASAA on this issue.

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[34] SEC Litigation Release No. 17923 (Jan. 9, 2003).

[35] NASD Notice 02-55, "NASD Requests Comments on Proposed New Rule 2712 and Amendments to Rule 2710" (Aug. 2002).

b. CRD–Expungement

The NASD filed with the Commission a proposed rule change, SR-NASD-2002-168, which proposes to establish procedures for expunging customer dispute information from the Central Registration Depository system. The proposed rule would require all arbitral directives to expunge customer dispute information from the CRD system to be confirmed or ordered by a court of competent jurisdiction. The proposed rule also would require member firms and associated persons seeking expungement to name the NASD as an additional party in any judicial proceeding seeking expungement relief or confirming an arbitration award containing expungement relief. The proposed rule would state that the NASD will participate in such judicial proceedings and will oppose expunging dispute information in the proceedings unless specific findings have been made that the subject matter of the claim or the information in the CRD system: (1) is without factual basis (*i.e.*, is factually impossible or clearly erroneous); (2) fails to state a claim upon which relief can be granted; (3) is frivolous; or (4) is defamatory in nature. The proposed rule would also permit member firms and associated persons to ask the NASD to waive the requirement to name the NASD as a party on the basis that the expungement order meets at least one of the standards for expungement articulated in the proposed rule. Since the Commission published the proposal for public comment in March of 2003, it has received extensive public commentary. The Division of Market Regulation is anticipating an NASD response to the comments prior to taking final action on the proposal.

c. Supervisory Control Over Customer Accounts

Adequate supervisory systems are integral to investor protection and to the integrity of the securities market. Operational and sales practice abuses can stem from ineffective supervisory control procedures. The recent Gruttadauria case,[36] which involved the misappropriation of customer funds, highlighted the ongoing problem of operational and sales practice abuses at firms and the importance of broker-dealer firms effectively monitoring their employees.

The NYSE and NASD have submitted proposals to amend their rules relating to supervisory control over customer accounts.[37] Specifically, the proposed rules would: (1) require members to develop general and specific supervisory control procedures that independently test and verify and modify, where necessary, the members' supervisory procedures; (2) require that office inspections be conducted by independent persons and include, at a minimum, the testing and verification of certain supervisory procedures; (3) expand upon a member's supervisory and record-keeping requirements with respect to changes in customer account name or designation in connection with order executions; and (4) clarify the time limit on time-and-price discretionary authority. The comment period expired on January 17, 2003. The Commission received numerous comment letters, which Commission staff and SRO staff are currently reviewing.

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[36] SEC Litigation Release No. 17590 (June 27, 2002).

[37] *See* NYSE 2002-36, Exchange Act Release No. 46858 [67 FR 72661] (Nov. 20, 2002); NASD 2002-162, Exchange Act Release No. 46859 [67 FR 70990] (Nov. 20, 2002).

d. Broker-Dealer Recordkeeping

The participants will discuss the Commission's recent amendments to its broker-dealer recordkeeping rules, Exchange Act Rules 17a-3 and 17a-4[38], in light of certain interpretive questions regarding the amendments.

7. Examination Issues

State and federal regulators discussed various examination-related issues of mutual interest, including examination priorities, summits and examinations

D. Enforcement

The enforcement working group addressed a range of topics during its session. Over 50 enforcement officials, including representatives from a significant number of states, Canadian provinces, the SEC's Division of Enforcement and each of the 11 SEC regional/district offices, attended the meeting. Also attending were senior enforcement staff from NASD-Regulation, Nasdaq, the NYSE, the U.S. Department of Justice (DOJ), the Federal Trade Commission (FTC), and the Commodity Futures Trading Commission (CFTC). The session was co-moderated by the SEC's Director of Regional Office Operations and the head of NASAA's Enforcement Section. A summary of the group's discussions follows:

1. SEC Trends and Priorities

The Director of the Division of Enforcement opened with a discussion of several of the SEC's current enforcement priorities, beginning with the continuing emphasis on financial and accounting fraud uncovered in the context of financial reporting failures and large restatements of earnings. This area remains a top enforcement priority for the Commission. A number of the major enforcement actions filed by the SEC that involved these kinds of frauds were described.

The senior SEC enforcement staff also discussed several of the enforcement "themes," including real time enforcement, credit for cooperation and harsher sanctions for recidivists and for those who try to obstruct the SEC's investigations, that will continue to be important in the upcoming year.

Another topic covered in some depth was the impact of the Sarbanes-Oxley Act on the SEC's enforcement program. The group discussed several of the new or modified remedies and powers provided to the Commission. Three studies mandated by the legislation to be prepared by the SEC's enforcement staff were described.

The need to focus more closely on various conflicts of interest in the securities industry (*i.e.*, ties between research and investment banking, IPO allocation practices, spinning, etc.) was highlighted. The status of the settlement negotiations regarding the research analyst cases was discussed, including the significant level of cooperation on this matter among the SEC, state securities regulators and SROs.

The SEC enforcement staff emphasized the continuing importance of developing better relationships with local and federal criminal prosecutors. In a growing number

[38] 17 CFR 240.17a-3, 17a-4.

of instances, available civil remedies do not stop some of the people behind today's frauds. Criminal prosecution and resulting jail time does. The SEC's Enforcement Director observed that the SEC has worked, over the past few years, with a substantial number of U.S. Attorney's offices nationwide on criminal securities cases. The development of good relationships among the SEC and both federal and local criminal prosecutors is a major priority of the Commission.

The establishment and role of the President's Corporate Fraud Task Force was cited both by the representatives from the SEC and the Justice Department as an example of the emphasis at the federal level on closer communication and cooperation between regulators and prosecutors. These relationships are even more important given the growing number of securities fraud investigations that have generated both civil and criminal enforcement actions.

In closing, the SEC senior enforcement staff, including the field offices heads, emphasized the necessity of continuing to coordinate and leverage the resources and remedial powers of the respective agencies represented at the meeting.

2. State Enforcement Trends and Priorities

The Chair of NASAA's Enforcement Section (the Securities Commissioner from Delaware) and certain other state securities administrators described the major trends and priorities of state securities law enforcement. They emphasized the importance of the states acting on a coordinated, multi-state basis, where appropriate, to enhance their message that state regulation of the securities laws is a critical and necessary complement to federal regulation.

The states continue to uncover sales practice abuses in a number of broker-dealer firms that promote and sell low-priced securities. The state regulators reported similar problems with networks of "independent contractors." Frauds involving foreign currencies, promissory notes, prime bank notes, variable annuities, coin-operated telephone leaseback investments and viatical settlements were highlighted as on-going concerns of state securities regulators. Certain state securities administrators noted an increase in suitability complaints associated with the sales of these products and indicated that more attention at the state level was being paid to the failure of brokers to properly supervise their employees.

They mentioned the continuing use of unlicensed/unregistered individuals, particularly independent insurance agents, to lure people into buying these investments. According to the state regulators, an increasing number of these agents, drawn by the high commissions, are relying solely on marketing claims provided to them by the promoters of the scams that are either misleading or false. These agents use the relationships and trust developed in the context of insurance sales to get their foot in the door to sell high-risk investments to their clients.

Similar to the SEC, the state securities administrators are finding that senior citizens are popular targets of today's promoters and that the sales pitches are emphasizing the safety and high returns of the products being sold—again playing on investors' concerns with the current volatility of the equity markets and the low interest rates on more legitimate debt instruments. The involvement of CPAs and attorneys in the sales of these investment products was noted.

State regulators also listed affinity group fraud, where a scammer uses a common religion or ethnicity to gain the victims' trust, as a continuing problem for them.

In response to the growing challenges facing state administrators, more emphasis is being placed on investor education initiatives and partnering with other regulators.

3. NASD, Nasdaq and NYSE Enforcement Trends and Priorities

Enforcement officials from three self-regulatory organizations, the NASD, Nasdaq and the NYSE, described several areas of concern and discussed various initiatives aimed at addressing those problems. Many of their concerns overlapped with those raised by the SEC and the state securities administrators. They included sales practice and trading abuses, market integrity issues, market manipulation and other issues generated by advances in technology. They discussed the impact of the market downturn and market volatility on their respective enforcement programs.

The NASD staff discussed a number of recent notices to NASD members and certain specific enforcement cases brought by their organization. They also highlighted issues involving the Commission's new books and records rule, the importance of effective disaster recovery plans, broker-dealer compensation arrangements, the impact of the consolidation of firms, variable annuities and supervision cases. The Nasdaq representative described enforcement initiatives regarding Nasdaq National Market System listings.

NYSE officials described several market surveillance and enforcement initiatives as well as a number of specific cases brought by the Exchange over the past year. They stressed their continuing focus in both the Exchange's enforcement and inspection programs on the existence of adequate internal controls and supervisory procedures within member firms. They indicated that they were experiencing an increase in sales practice complaints involving suitability, misappropriation of customer funds and unauthorized trades. They also cited a surge in complaints dealing with the sale of annuities. As a result of certain recent enforcement cases, the NYSE representatives noted that they were focusing on the adequacy of internal supervisory controls over "producing branch managers," the use of P.O. boxes and the verification of changes of address of account holders. And finally, they mentioned that, as part of their routine inspections, their examiners would be looking at firms' efforts to comply with the terms of the research analyst conflicts of interest settlement.

4. Department of Justice ("DOJ") and U.S. Attorney's Offices Securities Fraud Programs

The DOJ representative touched on what the Department and various U.S. Attorney's Offices around the country look for in potential criminal cases referred to them by civil agencies and by the securities self-regulatory organizations. He also indicated that he believed the Justice Department would continue to place a high priority on securities fraud cases and other forms of white-collar crime. The creation of the President's Corporate Fraud Task Force and its objectives were discussed.

All participants agreed that more regular meetings at both the national and local level between criminal and civil enforcement agencies would be helpful. Such meetings could facilitate the exchange of information, the development of joint or coordinated projects and the clarification of referral procedures. The SEC

representatives noted an increase in the number of U.S. Attorney's Offices around the country that were actively seeking to prosecute securities fraud cases.

5. FTC Enforcement Initiatives

The FTC representative focused his presentation on various consumer protection initiatives, including certain projects designed to better monitor the Internet for a range of consumer frauds. He encouraged the other regulators to consider participating in FTC Internet "surf days" and enforcement sweeps.

6. CFTC Enforcement Program

The Deputy Enforcement Director of the CFTC made a presentation on the current priorities of the CFTC's Enforcement Division. Of particular interest were the initiatives of the enforcement staff directed at various foreign currency exchange or "FOREX" scams. He cited examples of past and potential cooperation with other agencies, sharing of information, conducting parallel investigations and filing complementary enforcement actions.

E. Investor Education and Assistance

More than 25 individuals attended the investor education working group session, including representatives from five Canadian provinces, nine U.S. states, the District of Columbia, Puerto Rico, NASAA's Corporate Office, and the SEC's Office of Investor Education and Assistance. The working group discussed the following items:

1. Facts on Saving and Investing Campaign

In the spring of 1998, NASAA and the SEC, in conjunction with the Council of Securities Regulators of the Americas (COSRA), launched the *Facts on Saving and Investing Campaign*. The campaign is an ongoing, grassroots effort to educate individuals about saving, investing, and avoiding financial fraud. Over the past several years, members of NASAA have taken the lead in developing and implementing new campaign initiatives.

The 2003 campaign launched in April. NASAA and the Canadian Securities Administrators (CSA) developed an Investment Fraud IQ Quiz to measure the public's awareness of investment fraud, which was released on April 30th. The members of the working group received a copy of the quiz with an explanation of the answers. NASAA and CSA will measure the utilization of and responses to the quiz. During the working group session, members of NASAA described the programs they promoted during the 2003 campaign and shared ideas for new programs. Campaign highlights included legislation passed by both the U.S. House of Representatives and Senate proclaiming April 2003 as Financial Literacy for Youth Month. The states reported on some of their activities. Nevada printed *Ten Tips for Investors* from the Secretary of State in consumer's cable bills. Alabama developed a crossword puzzle that utilizes investment concepts.

The Canadian regulators discussed the ways in which their provinces and territories heightened their involvement in the campaign this year. The CSA declared April as Investor Education Month. The CSA also held a national contest for high school students regarding investing. The national winner will be announced soon. In addition, Newfoundland is using the Stock Market Game (Money Matters).

2. Youth Initiatives

In the spring of 1998, NASAA, NASD, and the Investor Protection Trust ("IPT") joined forces to launch "Financial Literacy 2001," an unprecedented $1 million campaign targeting 25,000 high school teachers across America. Recently renamed "Financial Literacy 2010" to reflect the ongoing commitment to offer the financial education program to teachers, the program aims to encourage—and make it easier for—teachers in every state to teach the basics on saving and investing. Working together, NASAA, the NASD, and the IPT have developed and updated a state-by-state customized classroom guide that will soon be available as a web-based system.

Participants in the working group discussed their efforts to promote FL 2010 in their respective jurisdictions and the challenges involved. NASAA reported that 24 states have established coalitions with the Jump$tart Coalition for Personal Financial Literacy, a 501(c)(3) nonprofit organization that seeks to improve the personal financial literacy of young adults. Six additional states report some activity with Jump$tart, but would not consider their programs to be "established" at this time. The District of Columbia and NASAA staff reported on their participation in the Wall Street Institute program. The Wall Street Institute offers after school education in investing concepts to youth. Members of the CSA talked about their partnership with Junior Achievement to access high school youth, noting that it did require an expenditure of funds.

3. Education on Troubling Trends and "Top 10" Scams

NASAA staff described their efforts to warn the public of various scams and cons that capitalize on news reports concerning the war in Iraq and terrorism fears. The "Top 10" scams consist of: unlicensed individuals, deceptive stock brokers, analyst research conflicts, promissory notes, prime bank schemes, viatical settlements, affinity fraud, charitable gift annuities, oil and gas schemes, and leasing scams.

The SEC staff reported a new trend in the use of fake seals and phony phone numbers. One ruse fraudsters use involves assurances that an investment has been registered with the appropriate agency. The fraudsters will purport to give the investor the agency's telephone number and invite the investor to verify the "authenticity" of their claims. Even if the agency does exist, the contact information almost certainly will be false. Another trick involves the misuse of a regulator's seal. The fraudsters copy the official seal or logo from the regulator's website—or create a bogus seal for a fictitious entity—and then use that seal on documents or web pages to make the deal look legitimate. The SEC published a new publication, *Fake Seals and Phony Numbers: How Fraudsters Try to Look Legit*, to warn investors of this scam.

The SEC also revised its investor education information on bankruptcy to address an increase in the number of investors who lose significant amounts of money (typically) when they buy, or hold onto, stock in companies that have declared bankruptcy. Even if the company successfully reorganizes and emerges from bankruptcy, it will typically cancel the old common stock. Investors holding this stock are then left with nothing.

4. Online Investor Protection

The Chair of NASAA's Online Trading Awareness Project Group discussed recent efforts to update the Investing Online Resource Center (IORC). Although the Securities Division of the Washington State Division of Financial Institutions originally created the IORC in December 1999, NASAA adopted the IORC as one of its official projects in January 2001.

Planned improvements for a 2003 re-launch include: adding flash to the interactive simulation that guides the user through the process of setting up an account and trading online; additional educational materials, such as a glossary of investment terms; investor alerts; and online trading in the news. The site continues to offer a self-assessment tool to help investors determine whether to consider trading online. It also provides links to helpful resources, including state regulators, the NASD, and the SEC.

The Director of the SEC's Office of Investor Education and Assistance briefed NASAA and the working group participants on its initiative to educate the public using bogus online investment opportunities. In January 2002, the SEC launched its first fake "scam" website—http://www.McWhortle.com—to warn investors about fraud *before* they lose their money. McWhortle proved to be a success worth expanding. In February 2003, the SEC launched its fourth fake scam site, http://www.growthventure.com/grdi/, which purports to be an off-shore hedge fund. The fund's name is Guaranteed Returns Diversified, Inc., or GRDI (pronounced *"greedy"*). GRDI invites the investor to invest in an off-shore hedge fund and shows the investor "other past successes" experienced by the company. When the investor clicks to invest, an education page alerts the investor of the scam.

5. Senior Educational Outreach

NASAA reported on a program in California named Seniors Against Investment Fraud ("SAIF"). SAIF educates seniors against investment and telemarketing fraud and trains them to teach other seniors. The U.S. Department of Justice provides the funding for SAIF.

The Ontario regulators have also developed a train the trainer program for seniors. New Brunswick offers the ABCs of Fraud to senior volunteers who put on skits to demonstrate scams regarding investing, home repair, and telemarketing. A peer counseling component is also available.

6. New Investor Education Programs

Participants in the working group session discussed recent investor education initiatives in their respective jurisdictions, including programs, workshops, and brochures designed to reach underserved populations such as rural communities, minority groups, elementary and high school students, and the elderly. Several jurisdictions discussed their efforts to offer materials that would alert the public to affinity fraud.

7. Investor Education Resources

NASAA reported on its new *Investor Education Program Development Guide* that is available to members. The guide offers a blueprint for developing an investor

education program, identifies jurisdictions with dedicated investor education funding, and provides contact information. NASAA also offers a cross-reference guide entitled *Member Investor Education Publications by Jurisdiction and Category*.

Participants in the Working Group session discussed existing resources for investor education—including brochures, videotapes, pre-packaged seminars, posters, online resources, and materials that have been translated into Spanish and French—and identified gaps.

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