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UNIFORM SECURITIES ACT

House Bill 6338 (Substitute H-2)
First Analysis (12-3-02)

Sponsor: Rep. Andrew Richner
Committee: Insurance and Financial Services

THE APPARENT PROBLEM:

Stated simply, Michigan's, as well as other states, securities law is woefully out of date. The current Uniform Securities Act was based on a 1956 uniform model act but was not adopted in Michigan until 1964. To date, thirty-seven jurisdictions have adopted the model act, in whole or in part. Several other states have adopted a more recent model act – the Revised Uniform Securities Act of 1985 (RUSA). Regardless of the model adopted, states have also modified their securities laws to varying degrees through the years. The result is that companies operating in more than one jurisdiction may find significant differences in securities law from state to state. In addition, investments, even by individuals, have become more global in nature, with investors seeking foreign investments in addition to domestic products. Advances in technology allow for more and more business transactions to be conducted electronically, though many laws restrict transactions to paper transmissions. Complicating the laws surrounding securities further is that several recent federal laws, such as the National Securities Markets Improvement Act of 1996 and the Securities Litigation Uniform Standards Act of 1998 have preempted many states' securities laws. Also, there have been many recent court decisions at the federal appeals level and by the Supreme Court that have affected securities laws.

To address the needs of the changing practices in securities law, the National Conference of Commissioners on Uniform State Laws (NCCUSL) has recently drafted and adopted a new uniform securities act. This model act incorporates changes brought about by the changes in federal law, recent court decisions, changes in technology, and the globalization of the economy, and represents an attempt to unify state practices. Legislation has been offered to replace the current securities act with the new NCCUSL model act.

THE CONTENT OF THE BILL:

The bill would repeal the existing Uniform Securities Act (MCL 451.501 to 451.818) and would replace it with the Uniform Securities Act (2002). The bill would take effect 180 days after its enactment. The bill is not a minor modification of the existing act; due to changes in technology that allows for electronic transactions and transmissions, a changing global economy, court decisions, and federal laws -- such as the National Securities Markets Improvement Act of 1996 (NSMIA) -- enacted since the mid-1990s, the bill would make significant changes and additions to many sections. The bill also closely follows the model uniform securities act adopted this year by the National Conference of Commissioners on Uniform State Laws (NCCUSL), though the bill does include some provisions unique to this state. Some current provisions and sections would be rewritten extensively or because of the revisions, would, like the section on small company offering registration, be eliminated.

The bill is organized into seven articles. A brief description of the content of the articles follows:

<u>Article 1: General Provisions</u>. The definitions of terms are concentrated in Article 1. Many new definitions would be added, including definitions of "depository institution", "institutional investor", "international banking institution", and "self-regulatory organization". "Bank" would mean a banking institution organized under the laws of the U.S.; a member bank of the federal reserve system; any other banking institution that met all of the following: 1) it was doing business under the laws of a state or of the U.S.; 2) a substantial portion of its business consisted of receiving deposits or exercising fiduciary powers similar to those permitted to be exercised by national banks under the authority of the comptroller of the currency pursuant to federal law; 3) it was supervised and examined by a state or federal agency having supervision over banks; and 4) it was not operated for the purpose of evading the

bill; or a receiver, conservator, or other liquidating agent of any institution or firm included in the above.

Many other definitions would be expanded or otherwise amended. For example, the bill would specify that "broker-dealer" would not include an international banking institution or a depository institution (an insurance company, organization primarily engaged in the business of insurance, a Morris Plan bank, or an industrial loan company would not be included as a "depository institution"). Further, the definition of "security" would be revised. Changes include the addition of an investment in a viatical or life settlement agreement, certain common enterprises, creating investment contracts, and the inclusion of both a certificated and an uncertificated security. (Note: Banks and savings institutions now have a blanket exemption from the definition of "broker-dealer"; this would remain the same.)

As to what a "security" doesn't include, the bill would specify that security does not include an insurance or endowment policy or annuity contract under which an insurance company promised to pay a fixed or variable sum of money either in a lump sum or periodically for life or other specified period. The previous exclusion for "a commodity contract" would be deleted.

The bill contains references to many federal statutes, and specifies that the references to federal statutes would include the statute and rules and regulations adopted under it. The administrator, which would be the Office of Financial and Insurance Services (OFIS), could (by rule or order) adopt rules and regulations adopted under the federal statutes defined in the bill or their successor acts, a federal statute similar to one defined in the bill, or a rule or regulation similar to a rule or regulation adopted under the statutes defined in the bill. A reference to a federal agency or department would also be a reference to any successor agency, department, or entity.

Further, the bill would modify, limit, and supersede the Electronic Signatures in Global and National Commerce Act, except for Section 101(c), 15 U.S.C. 7001. Neither would the bill authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. 7003. The bill would authorize the filing of records and signatures, when specified by provisions of the bill or by a rule or order, in a manner consistent with Section 104(a) of the federal statute, 15 U.S.C. 7004.

Article 2: Exemptions from Registration of Securities and Transactions. Though some of the bill's provisions pertaining to registration exemptions for securities follow closely the language of the current act, the bill would delete some obsolete provisions and modify others to conform to current federal law and recent court decisions. (Note: Regarding insurance company securities, the bill as written would continue to exempt insurance, endowment policies, or annuity contracts under which an insurance company promised to pay fixed or variable sums. (A variable annuity or other variable insurance product not issued by a registered investment company would be subject to the anti-fraud provisions contained in the bill.)

The bill would include, as an exempted security, certain federal covered securities; securities listed or approved for listing on markets specified by rule under the bill (which, according to information supplied by NCCUSL, would include securities listed on the New York or American Stock Exchanges, or Nasdaq National Market); specified options, warrants, and rights; and certain derivative securities. Regarding securities issued by nonprofit organizations, the bill would continue to extend the exemption only to those securities of which no part of the net earnings inured to the benefit of a private stockholder or other person, or a security of a nonprofit company that was excluded from the definition of an investment company under the Investment Company Act of 1940. Further, the bill would contain an exemption for securities issued by cooperatives and for equipment trust certificates meeting certain criteria in respect to equipment leased or conditionally sold to a person.

The bill is different from some of the provisions in the current act regarding transactions that are exempt from registration, would eliminate other provisions, and would add a number of new provisions; all changes follow the NCCUSL model act. Changes include nonissuer transactions in specified foreign transactions; nonissuer transactions with federal covered investment advisers; specified exchange transactions; rescission offers; out-of-state offers or sales; employee benefit plans; and an exemption for nonissuer transactions involving specified foreign issuer securities traded on designated securities exchanges – specifically, Toronto Stock Exchange issuers that are public reporting issuers under Canadian securities law and that meet the 180-day continuous reporting requirement.

A rule or order under the bill could exempt a security, transaction, or offer, or a class of securities, transactions, or offers, from any or all of the requirements of Sections 301 to 306 and 504 (which pertain to securities registration, registration filings, and denial, suspension, and revocation of securities and also filing of sales and advertising literature). Also, an order or rule could waive any or all of the conditions for an exemption under Section 201 and 202 pertaining to exempt securities and transactions. Except with respect to a federal covered security, an order of the administrator could deny or suspend application of, condition, or limit an exemption created under several sections of the bill with respect to a specific security, transaction, or offer. A person would not be in violation of a denial or suspension order by an offer to sell or purchase, a sale, or a purchase made after the entry of an order under Section 204 of the bill if the person did not know, and in the exercise of reasonable care, could not have known of the order.

Article 3: Registration of Securities and Notice Filings of Federal Covered Securities. The provisions in Article 3 closely follow the current act, though there are a few additions and modifications that follow the NCCUSL model act. Securities allowed to be offered or sold under the bill would be federal covered securities; a security, transaction, or offer exempted under the bill; or a security that was registered under the bill. A rule or order under the bill could require, for a security issued by an investment company that issued a federal covered security, certain records to be filed.

Modifications would be made to provisions pertaining to the conditions under which a registration statement would become effective and also to provisions regarding rules or orders that place conditions on registration. In addition, the bill would allow a rule or order to require as a condition of registration that a security registered under the bill be sold only on a specified form of subscription or sale contract and that a signed or conformed copy of each contract be filed under the bill or preserved for a period specified by the rule or order but not more than five years. If a posteffective amendment increased the number of securities to be offered or sold, an additional registration fee would be required.

The bill would continue to allow a stop order on an offering that was being made on terms that were unfair, unjust, or inequitable. To the extent practicable, the administrator would have to publish guidelines, rules, or orders that provide notice of conduct that violates a provision allowing stop orders for offerings that would work a fraud upon purchasers or that had been made with unreasonable amounts of underwriters' and sellers' discounts, commissions, and so on. However, the administrator could not institute a stop order proceeding against an effective registration statement on the basis of conduct or a transaction known to the administrator when the statement became effective unless the proceeding were instituted within 30 days after it became effective. Further, the administrator could waive or modify, in whole or in part, any or all of the requirements of Sections 302, 303, and 304(2) or the requirement of any information or record in a registration statement or in a periodic report under Section 305(9).

Article 4: Broker-Dealers, Agents, Investment Advisers, Investment Adviser Representatives, and Federal Covered Investment Advisers. Article 4 rewrites provisions currently contained in Section 201 regarding broker-dealers and so forth. The revisions incorporate court decisions and recognize the increasingly transnational nature of securities brokerage. Section 402 contains a long list of individuals exempt from registration requirements. An individual would be prohibited from acting as an agent for more than one broker-dealer or more than one issuer at a time (unless the broker-dealer or issuer for which the agent acts were affiliated by direct or indirect common control or were authorized by rule or order under the bill). The registration of an agent would be effective only while he or she were employed by or associated with a broker-dealer registered under the bill or an issuer that was offering, selling, or purchasing its securities in Michigan.

An investment adviser could not employ or associate with an individual required to be registered under the bill as an investment advisor representative (who would transact business on behalf of the investment advisor) unless the person was properly registered or exempt from registration. Similarly, an investment adviser could not employ or associate with any individual to engage in activities related to investment advice if the registration of the individual were suspended or revoked or the individual were barred from employment or association with persons in the securities business, unless the investment adviser did not know or could not have known of the suspension, revocation, or bar. The administrator could waive, in whole or in part, the application of these prohibitions upon request and good cause shown.

The bill would require investment adviser representatives to be registered, and would also provide some exemptions from registration. A person could maintain dual registration as an agent and an investment adviser representative. The bill would also rewrite provisions that had been amended by Public Act 494 of 2000 regarding federally covered securities and federally covered advisers to comply more closely with requirements of the National Securities Markets Improvement Act of 1996 (NSMIA). This section of the bill would also provide for information required to be on or with applications for registration as a broker-dealer, agent, investment adviser, or investment adviser representative; applicable registration fees; termination or transfer of employment or association; postregistration requirements; financial requirements and recordkeeping; and registration sanctions.

Neither an agent nor an investment adviser representative could have custody of funds or securities of a customer unless supervised according to the bill's requirements. The administrator could prohibit, limit, or impose conditions on the custody of funds or securities of a customer by a broker-dealer or an investment adviser. Individuals registered under Sections 402 or 404 could be required, by rule or order, to participate in SEC-approved continuing education programs. The bill would also specify conduct that would be prohibited for a broker-dealer acting as a finder.

Provisions pertaining to registration sanctions or restrictions generally follow current law, but, according to NCCUSL, would be modified to reflect subsequent developments that have broadened the scope and remedies of counterpart federal and state statutes. Under the bill, if the administrator found that an order was in the public interest and was authorized under provisions of the bill, an order could censure, impose a bar, or impose a civil penalty in an amount not to exceed $10,000 for a single violation or $500,000 for multiple violations. Some disciplinary measures could only be imposed for violations within the previous ten years. A person could be disciplined under provisions of the bill if he or she, among many things, were convicted of any felony or within the previous ten years had been convicted of a misdemeanor involving a security, a commodity futures or option contract, or an aspect of a business involving securities, commodities, investments, franchises, insurance, banking, or finance. The administrator would be prohibited from instituting disciplinary proceedings solely based on material facts actually known by the administrator unless an investigation or the proceeding were instituted within one year after the administrator actually knew the facts.

<u>Article 5: Fraud and Liabilities</u>. Much of Article 5 follows current law, but several sections have been modified to more closely follow federal law and incorporate recent court decisions. The bill would define the allowable scope of a rule issued under the bill, including specifying the contents of an investment advisory contract entered into, extended, or renewed by an investment adviser. In a criminal proceeding under the bill, a person claiming an exemption, exception, preemption, or exclusion would have the burden of going forward with evidence of the claim. Though willfully violating the bill or a rule or order issued under the bill (except for a few specified provisions) would be a felony (as it is now) punishable by imprisonment for not more than ten years or a fine of not more than $500,000 for each violation, or both, the bill would specify that an individual convicted of violating a rule or order could be fined, but not imprisoned, <u>if</u> the individual did not have knowledge of the rule or order.

The bill would establish a qualified immunity in that a broker-dealer, agent, investment adviser, federal covered investment advisor, or investment adviser representative would not be liable to another of the same for defamation relating to an alleged untrue statement contained in a record required by the administrator or his or her designee, the SEC, or a self-regulatory organization, unless it were proved that the person knew or should have known at the time the statement was made that it was false in a material respect or the person acted in reckless disregard of the statement's truth or falsity.

The bill would state that enforcement of civil liability under Section 509 would be subject to the Securities Litigation Uniform Standards Act of 1998. This section on civil liability would be significantly rewritten to conform to provisions in the federal law. Currently, a purchaser can bring an action against an individual who sells a security in violation of the bill's prohibitions to recover the consideration paid for the security and to recover damages. The bill would specify that <u>actual</u> damages would include costs and reasonable attorney fees as determined by the court.

A person would be liable to the seller under specified circumstances; therefore, the bill would allow a seller to maintain an action for securities fraud against a buyer to recover the security, income received on the security, costs, and reasonable attorney fees on the tender of the purchase price or for actual damages as provided in the bill. A person acting as a broker-dealer or agent that sells or buys a security in violation of the bill and a person acting as an investment adviser or investment adviser representative who provided investment advice for a fee in violation of the bill's provisions would also be liable to the customer or client and the customer or client could maintain an action. Any person who received any consideration for providing investment advice to another and who employed any deceptive practices in order to defraud the other person would be liable to that person. For each civil action allowed by the bill, a description of what damages and costs could be recovered is given.

The bill would establish time limits for the commencement of civil actions as well as specify conditions under which a purchaser, seller, or recipient of investment advice could not maintain a civil action.

<u>Article 6: Administration and Judicial Review</u>. Many current provisions have been incorporated into the bill, but, like other sections of the bill, many sections in Article 6 have been modified to reflect current trends, recent court decisions, and federal law. One new provision is that the administrator could develop and implement investor education initiatives to inform the public about investing in securities, with particular emphasis on the prevention and detection of securities fraud. Such ventures could be done in collaboration with public and nonprofit organizations.

The bill would create the Securities Investigation, Enforcement, and Education Fund as a revolving fund within the state treasury. The administrator could accept grants or donations from persons not affiliated with the securities industry or from nonprofit organizations to develop and implement investor education initiatives. Fees and civil fine revenue generated under the bill would be deposited into the fund. Money appropriated to the fund would not revert to the general fund at the end of a fiscal year. Expenditures from the fund would be restricted to those purposes specified in the bill.

As now, the administrator would have the power, during investigations, to compel a person to produce documents, be a witness, etc. The administrator could refer a matter to the attorney general or appropriate county prosecutor who could apply to a circuit court if a person failed to appear, refused to testify or produce records, and so on. The bill would specify that the court could hold the person in contempt, order the person to appear, order a person's testimony, order the production of records, grant injunctive relief, impose a civil fine (the bill would increase fine amounts significantly – amounts now specified as $1,000 would be increased to $10,000 and amounts currently specified as $10,000 would be increased to $500,000), or grant any other appropriate relief. A person could also apply to the circuit court for relief from a request to appear, testify, obey a subpoena, or produce documents.

The bill would outline the assistance that the administrator may provide to an administrator from another state or foreign jurisdiction when the latter is investigating a matter that is under the former's authority. The bill would also broaden the civil remedies available to the administrator through the circuit court when it appears to him or her that a person has, is, or is about to engage in a prohibited act or course of business (e.g., freezing assets, taking charge and control of a defendant's property, and/or imposition of a civil fine of not more than $10,000 for a single violation or $500,000 for multiple violations). As now, the administrator would also have the power to issue a cease and desist order or an order denying, suspending, revoking, or conditioning specific allowable exemptions for a broker-dealer or an investment adviser. The bill would require the administrator to make findings of fact and conclusions of law in accordance with the Administrative Procedures Act before issuing a final order and allow the imposition of a civil fine (no more than $10,000 for a single violation or $500,000 for multiple violations) or charges for actual costs of an investigation or proceeding in a final order. A court could find a person in contempt and impose an additional civil fine of <u>between</u> $10,000 and $500,000 for <u>each</u> violation if a person did not comply with a final order, as well as granting any other relief determined by the court to be just and proper.

A penalty under the bill could not be imposed nor would liability arise from conduct engaged in or omitted in good faith conformity with a rule, form, or order of the administrator. All rules, forms, interpretative opinions, and orders would have to be made available to the public. However, a number of records would not be public records and so would not be available for public examination; for instance, records that contain trade secrets or confidential information, records containing personal information such as a Social Security number or address, and a record obtained by the administrator in connection with an audit or inspection under Section 411(4) or an investigation under Section 602 (however, this information could be disclosed for the purpose of a civil, administrative, or criminal investigation, action, or proceeding).

The administrator would have to cooperate, coordinate, consult, and subject to the bill's provisions, share records and information with securities regulators in other states, Canada, other foreign jurisdictions, the SEC, and so forth in order to effectuate greater uniformity in securities matters between the federal government, self-regulatory organizations, and state and foreign governments. Cooperation authorized by the bill would have to include such things as developing and maintaining uniform forms, conducting a joint examination or investigation, instituting and prosecuting a joint civil or administrative proceeding, sharing and exchanging personnel and records, formulating common systems and procedures, and developing and maintaining a uniform exemption from registration for small issuers and taking other steps to reduce the burden of raising investment capital by small businesses.

Both final orders and rules adopted under the bill would be subject to judicial review pursuant to the Administrative Procedures Act. The bill would also rewrite the sections pertaining to consent to service of process. Further, the bill would specify that if any provision of the bill or its application to any person or circumstance were held to be invalid, the invalidity of that particular provision or application would not affect other provisions or applications that could still be given effect without the invalid provision or application. To that end, the provisions of the bill would be severable.

Article 7: Transition. The bill would repeal the existing Uniform Securities Act and would replace it with the Uniform Securities Act (2002). The bill would take effect 180 days after its enactment. The existing act would exclusively govern all actions, prosecutions, or proceedings that were pending or that were maintained or instituted on the basis of facts or circumstances occurring before the bill's effective date. However, a civil action could not be maintained to enforce any liability under the current act unless it had been commenced within any period of limitation that applied when the cause of action accrued or within three years after the bill's effective date, whichever was earlier.

In addition, all effective registrations under the current act, all administrative orders relating to the registrations, statements of policy, interpretative opinions, declaratory rulings, no action determinations, and all conditions imposed upon registrations under the current act would remain in effect for the same time period they would have remained in effect if the bill had not been enacted. Though considered to have been filed, insured, or imposed under the bill, they would be governed by the current act. Further, the current act would exclusively govern any offer or sale made within one year after the bill's effective date that was related to an offering made in good faith before the bill's effective date on the basis of an exemption available under the current act.

BACKGROUND INFORMATION:

The majority of states and U.S. territories operate under the 1956 model uniform securities act. Several states operate instead under the Revised Uniform Securities Act of 1985 (RUSA). In 1996, the federal National Securities Markets Improvement Act preempted much of these state acts in regards to federal covered securities. Though Michigan revised its securities act to comport with the federal changes, not all states did so. (For more information, see the House Legislative Analysis Section's analysis of enrolled House Bill 5763, which became Public Act 494 of 2000.) The Securities Litigation Uniform Standards Act of 1998 also preempted parts of both the 1956 act and RUSA.

Beginning in 1998, the drafting committee of the National Conference of Commissioners on Uniform State Laws (NCCUSL) has reviewed a number a drafts before adopting a final draft earlier this year. (The model act, along with prefatory notes, is available on NCCUSL's web site, www.nccusl.org.) The drafting committee was assisted by advisors, consultants, and observers from many interested groups such as, among many others, the American Bankers Association, the American Council of Life Insurers, the National Association of Securities Dealers, Inc., the Securities and Exchange Commission, associations representing financial planners, and the American Bar Association. The membership of the drafting committee charged with revising the Uniform Securities Act included Representative Andrew Richner, chair of the Michigan House of Representative's standing committee on Insurance and Financial Services.

FISCAL IMPLICATIONS:

Fiscal information is not available.

ARGUMENTS:

For:

The financial world has changed significantly since 1964 when the current securities act was enacted (and even more so since 1956 when the model act the

Michigan law was based on was first drafted). Besides the technological advancements that allow for many business transactions to be conducted by electronic transmissions, the business of securities investments is increasingly operated across state and federal boundaries as the economy becomes much more global in nature. Add to that the effect of myriad federal laws and federal court cases that have preempted much of the 1956 model act or changed the many securities industry practices. It isn't surprising that the "uniform" securities law may no longer be in conformity with other states' laws or may be inadequate to regulate the new world that those in the security industry operate in.

The rationale of having uniform state laws to govern certain business sectors makes sense as companies increasingly do business across state lines or federal boundaries (e.g., Canadian companies offering products or services in the U.S.). It can be a costly and burdensome undertaking to operate under many regulatory schemes with varying licensing or registration criteria, penalties, and so on. Further, as people relocate from state to state, it can be helpful to know that those who offer investment advice or market securities products are operating under similar regulatory frameworks (as opposed to reading the securities laws of every state one moves to); even general knowledge of the laws that regulate the types of products that can be offered by a particular industry member (e.g., broker/dealer, agent, insurance agent, investment advisor, etc.) may enable a person to recognize a fraudulent business practice. Further, if problems arise, it is helpful and in the consumer's best interest that provisions pertaining to allowable civil actions be consistent from state to state so that consumers are not disadvantaged by differences in procedures or statutes of limitations.

For:

The bill would effectively address many of the challenges previously articulated regarding the changing world of securities laws and investments. Though the bill closely follows the NCCUSL model act, provisions in the bill regarding fees and civil fines represent local practice. Additionally, though many sections of the 1956 act have been significantly rewritten to update the provisions, many sections have been left virtually unchanged. However, it is important to realize that the bill does represent many changes from current practice. For example, the bill would allow the OFIS commissioner to adopt further exemptions from registration requirements for securities, transactions, or offers – without statutory amendment – than what is explicitly stated in the bill. The three main themes of the bill are as follows: First, the bill would bring a greater uniformity with other jurisdictions and cooperation among relevant state and federal governments, self-regulatory organizations, and investor protection; secondly, the bill would incorporate changes consistent with provisions of the National Securities Markets Improvement Act of 1996 (NSMIA), although the state had already adopted many of these provisions in 1998 legislation; and thirdly, the bill would include provisions that would allow for electronic records, signatures, and filing, and would permit the filing of electronic filing in central information depositories.

The bill would make other significant changes. It includes new definitions to define "bank", "depository institution", investment advisor representative, and other terms; and broadens certain exemptions from securities registration. In a departure from the model act, the bill would preserve the current practice of giving banks, savings institutions, and other depository institutions a blanket exemption from registration as a broker/dealer (whereas the model act would require these institutions to register as a broker/dealer in some instances). The bill would create a new qualified immunity provision to protect a broker/dealer or investment adviser from certain defamation claims and shorten the statute of limitations for certain civil actions. It would increase enforcement tools available to the administrator against violators, including asset freezes, rescission orders, and increased fine amounts for civil penalties, including a civil fine for contempt if an order is not complied with (civil fine amounts currently listed at $1,000 would be increased to $10,000 and fine amounts currently listed at $10,000 would be increased to $500,000). Further, the bill would clarify the scope of nonpublic records.

In addition, the bill reflects some provisions of the model act pertaining to administrative rulemaking and adjudication, service of process, judicial review of administrative adjudications, public records, public hearings, and use immunity. According to NCCUSL, model acts generally defer to existing state procedural provisions on such matters, but the commission decided to include these matters in the model act to promote greater uniformity of securities regulation. Overall, proponents say that the bill would streamline and modernize securities regulation in the state, increase enforcement capabilities of the state administrator, and increase consumer protection. Michigan would be the first state to adopt the new model act. Enactment of the bill would encourage other states to give the model act prompt consideration.

For:

Unique to the bill is the provision creating the Securities Investigation, Enforcement, and Education Fund. (The model act calls for creation of a Securities Investor Education and Training Fund.) The bill would also significantly increase the amount that could be imposed for civil fines and allows for an additional fine to be imposed for contempt of an order. A fine could be as high as $500,000 per violation in some circumstances. All revenue generated by registration fees and civil fines would be for investigation and enforcement activities as well as to develop consumer education initiatives. These endeavors represent important and significant consumer protection measures. As consumers become more investment savvy, they will be able to proactively protect themselves from fraudulent and deceptive practices. They will also be aware of suspicious practices or advice that indicates a need to contact the state administrator for further investigation. It is important to provide sufficient revenue for proper enforcement of securities laws, considering that an unscrupulous agent offering unsuitable investment products, bad investment advice, or engaging in fraudulent schemes can literally wipe out a person's life savings. Further, the business of investments grows increasingly complicated as new products are developed or practices modified over time or changed by amendments to law or court decisions. A well-funded agency equipped with the necessary tools and resources can do much to catch wrongdoers, but also could do much to assist businesses in complying with the laws of the state.

Response:

It is unclear how current laws regulating the distribution of civil fine revenue would interact with the bill's provisions. Currently, the state constitution requires revenue from penal fines to be distributed to libraries. Provisions in the Revised Judicature Act detail the distribution of civil fine revenue collected by district courts. However, there is no statute detailing the distribution of revenue collected by a circuit court, though the court is authorized to collect revenue generated by fines imposed for violations of state law or regulations; however, general rules would appear to funnel the revenue collected to the local funding unit. Perhaps more consideration is needed to rule out any conflicts with current law.

Further, if a person did not comply with an order issued under the bill, a court could hold a person in civil contempt of the order and could impose an additional fine of at least $10,000 but no more than $500,000 for each violation. *Black's Law Dictionary* defines civil contempt as the "failure to do something which the party is ordered by the court to do". However, the bill would allow a court to hold a party in civil contempt for failing to comply with an order of the <u>administrator</u> – meaning the commissioner of OFIS. This would appear to be a departure from general law practice and should be reviewed.

Against:

A variable contract is a hybrid product that combines components of insurance with securities. Sales of these products have increased over the past decade. With benefits such as tax-deferred growth, variable annuities are often attractive as a vehicle for retirement savings. However, they are not risk free and can present investment risks similar to a stock or mutual fund investment. If the bill <u>included</u> variable annuities as a security but <u>exempted</u> variable insurance products from securities registration (as the introduced version would have done), state securities administrators could still bring enforcement actions regarding variable insurance sales practices because anyone selling these products would have to be registered under the bill. However, a committee amendment excluded variable annuity products from the definition of a security. It is important that the sale of these products be subject to the bill's suitability requirements (meaning that the sale of a security can come under scrutiny as to the "suitability" of that type of security over another type of security or investment for a particular client).

Mary Schapiro, President of Regulatory Policy and Oversight, National Association of Securities Dealers (NASD), a self-regulatory organization for the securities industry to which every broker/dealer in the U.S. who conducts a securities business must belong, listed additional reasons why variable products should be included in the definition of a security in a letter to the commissioner of OFIS. In her letter, Ms. Schapiro wrote that NASD found that "variable contracts' sales-related problems parallel those of mutual funds and other securities." The problems found by the NASD included "misleading advertising, unsuitable recommendations, switching and churning of customer accounts to increase sales commissions, and failure to disclose fees and other important characteristics" of such contracts. ("Churning" is an industry term for replacing existing investments with other investment products. The insurance industry uses the term "replacement transactions" to refer to the same practice.) Ms. Schapiro went on to write that "[b]ecause of the substantial similarities between variable contracts and other securities products, we believe it is incongruous for agents and sales practices involved in variable contracts not to be covered by state securities laws."

Further, according to information contained in the prefatory notes of the NCCUSL model act, it is also the view of the North American Securities Administrators Association (NASAA) that variable products should be exempted from registration, but be included in the definition of a security. NASAA cites case law in which the U.S. Supreme Court ruled that a variable annuity is a security in *SEC* v *Variable Annuity Life Insurance Company of America*, 359 U.S. 65 (1959) and a federal appeals court decision confirming that "variable insurance products are 'covered securities' as defined in the National Securities Markets Improvement Act of 1996 (NSMIA) and in the Securities Litigation Uniform Standards Act of 1998 (SLUSA)" by *Lander* v *Hartford Life Annuity Insurance*, 251 F 3rd 101 (2d Cir 2001).

Unless variable products are included the definition of a security, the state regulator (in this case, the commissioner of OFIS) would not have direct access to regulate the people who sell variable annuity products. Without this authority, the consumer protection provisions of the bill could not be extended to cover the sales methods used to market variable products.

Response:

According to information from NCCUSL that expressed the view of the American Council of Life Insurers, excluding variable products from the definition of a security recognizes that 37 jurisdictions currently exclude all insurance, endowment, and annuity contracts from this classification. The amendment also recognizes that the issuance and sale of annuity contracts is already regulated on three levels – by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), and by each state insurance regulator under state insurance laws. A fourth level of regulation is added for some products as group life and annuities are also regulated by the federal Department of Labor. Further, excluding variable products from the definition of securities "prevents a statutory conflict with [up to] 48 jurisdictions that grant the insurance commissioner exclusive jurisdiction to regulate the issuance and sale of variable contracts."

In addition, opponents of including variable annuities in the definition of security maintain that no real demonstrated cases of abuse in the state have been presented to support the potential increased costs for companies – primarily insurance companies – to come under yet another level of regulation in order to market variable products.

Also, some in the industry feel that the unfair trade practices provisions and other oversight provisions of the Insurance Code and administrative rules already provide the commissioner the necessary regulatory oversight and ability to discipline unscrupulous agents or businesses. For example, under departmental rules, insurers offering variable life insurance policies must adhere to a standard of conduct that includes standards of suitability (generally based on criteria established by the National Association of Insurance Commissioners). Further, replacement of life insurance policy transactions also come under close scrutiny with mandatory reporting requirements on the part of the insurance agent and insurer. These provisions should be sufficient to protect consumers without increasing the regulatory burden on the insurance industry.

Rebuttal:

Though departmental rules do appear to create "suitability-like" provisions with regard to variable and fixed life insurance policies, they do not appear to apply to fixed or variable annuity contracts, which by rule are excluded from the definition of "life insurance". If so, fixed and variable annuity contracts could indeed fall through a regulatory crack. In light of the potential risk to investors, the state securities regulator (the commissioner of OFIS) should be able to oversee the distribution aspect of these products for suitability along with other investment products that will fall within the definition of a security. Therefore, the bill should be amended to reflect federal securities law and federal court decisions that include variable products as securities.

Against:

Currently, a person may obtain relief under the code if a civil action is brought within two years of when the violation occurred. The bill instead would specify that relief could only be obtained if an action was commenced within the following time limits:

• For a violation of Section 301 (which specifies the securities that may be legally sold), transacting business as a broker-dealer or agent without being registered or exempted from registration, or making a misrepresentation regarding a notice filing or application filing, etc., the action would have to be commenced within one year after the violation occurred.

• For an action regarding sales of a security involving certain untrue statements of material facts or involving fraud or deceit, an action would have to be commenced within two years after discovery of the facts constituting the violation or five years after the violation occurred, whichever was earlier.

Instead of shortening the statute of limitations, the bill should increase the one-year limit imposed by the bill to three years in the first case and increase the time limit to three years after the discovery of the facts but not longer than five years after the violation occurred in the second case. According to an attorney who offered testimony regarding this issue, discussions with attorneys who represent buyers of securities have revealed that the current two-year statute of limitation is too short. Too short of a time frame results in cutting off otherwise valid strict liability claims because a buyer may not be aware of the loss until after the two-year period (which would be shortened to one year under the bill). Reportedly, this is especially true regarding elderly clients and/or those who are not financially or investment savvy. In addition, with the volatility of the current equity market, it may not become apparent to an investor that he or she had been misled about an investment until long after the allowable filing time. Therefore, for greater consumer protection, the statute of limitations for filing should be increased, not shortened. At the least, the issue deserves to be looked at more closely before final passage of the bill.

Further, in the provision permitting a person to bring an action against a seller that was cited in the first case above, the bill states that a person could recover reasonable attorney fees <u>as determined by the court</u>, in addition to other recoverable damages. Apparently, the emphasized phrase should be stricken as current law does not require court determination of "reasonable attorney fees". Also, the provision as written does not seem to capture the spirit of allowing a purchaser to recover against a seller who violated the bill, as the person should be able to recover the entire amount of damages suffered, including the entire cost of hiring an attorney. In addition, some believe that a literal reading of the bill would prohibit the award of costs and attorney fees from an arbitration proceeding, since such a proceeding is not a court. It would be unfair to customers who must use arbitration (such as those bringing an action against a brokerage firm – all of which reportedly require arbitration of claims). This could inadvertently benefit violators by using a non-court dispute resolution forum to reduce the damage amount that would have to be paid.

Response:
Reportedly, the current trend nationally is to lower the statute of limitations. In the second case detailed above, the bill represents the federal securities law statute of limitations as amended earlier this year by the federal Sarbanes-Oxley Act. The shorter time frame is believed to discourage forum shopping.

POSITIONS:

The American Council of Life Insurers supports the committee-passed version of the bill. (11-26-02)

The Life Insurance Association of Michigan supports the bill as amended. (11-25-02)

Prudential supports the bill. (11-25-02)

Manulife U.S.A. supports the bill. (11-25-02)

AIG supports the bill. (11-25-02)

The Office of Insurance and Financial Services supports the bill but would prefer that variable annuities be included in the definition of securities. (12-2-02)

The Michigan Bankers Association is not opposed to the bill. (11-25-02)

Analyst: S. Stutzky

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.