



May 30, 2014

Mr. Ronald W. Thomas
Director
Virginia State Corporation Commission
Division of Securities & Retail Franchising
P.O. Box 1197
Richmond, VA 23218

Re: Rule 21 VAC 5-20-280 A (32)
**Joint legal analysis: NSMIA preempts the
rule's point-of-sale disclosure requirements**

Dear Mr. Thomas:

On behalf of the Securities Industry and Financial Markets Association (“SIFMA”)¹ and the Financial Services Institute (“FSI”)², we are writing to provide you with our joint legal analysis in support of our view that the point-of sale disclosure requirements in Rule 21 VAC 5-20-280 A(32) (the “Rule”) are preempted by, among other things, Section 103 of the National Securities Markets Improvement Act of 1996 (“NSMIA”).

As you will recall, on December 11, 2013, SIFMA provided you with our preliminary legal analysis concluding that the Rule was preempted by both NSMIA and Securities Exchange Act of 1934 implementing regulations. Five days later, on December 16, 2013, the Division of Securities and Retail Franchising of the Virginia State Corporation Commission (the “Division”) issued a Statement of Policy (the “Statement”) addressing enforcement of the new Rule.³

In the Statement, the Division concluded that the Rule’s writing and record requirement at the point of confirmation may be preempted under NSMIA and thus, the Division stated that it would not audit for compliance or pursue enforcement actions for failing to comply with that provision of the Rule. The Division, however, did not draw the same conclusion with respect to the Rule’s point-of sale disclosure requirements and thus, reserved the right to pursue enforcement actions under that provision.

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

² FSI was founded in 2004 with a clear mission: to ensure that all individuals have access to competent and affordable financial advice, products and services delivered by a growing network of independent financial advisors and independent financial services firms.

³ The Statement of Policy is available online at: <https://www.scc.virginia.gov/srf/bus/sifma.pdf>.

The purpose of this letter is to provide you with our further legal analysis and background information in support of the conclusion that the Rule's point-of sale disclosure requirements are in fact also preempted by NSMIA, among other things.⁴

1. The original Rule applied only to penny stock transactions, and was modeled after substantially similar federal rules that require record-keeping.

Prior to June 2013, the Rule, in its original form, was set forth in Section E(6)(a) and prohibited *"Failing to advise the customer, both at the time of solicitation and on the confirmation, of any and all compensation related to a specific securities transaction to be paid to the agent including commissions, sales charges, or concessions."*⁵ Section E of the Rule stated that *"[t]he purpose of this subsection is to identify practices in the securities business which are generally associated with schemes to manipulate and to identify prohibited business conduct of broker-dealers or sales agents."*⁶ Section E(6) further clarified that the Rule *"specifically appl[ied] only in connection with the solicitation of a purchase or sale of OTC (over the counter) unlisted non-NASDAQ equity securities."*⁷

As originally drafted, the Rule was substantially similar to Exchange Act Rules 15g-4 and 15g-5, which require a broker-dealer or associated person, in connection with a penny stock transaction, to disclose at the point-of-sale (either orally or in writing) and upon confirmation, the aggregate amount of any compensation received by them in connection with the transaction.⁸ Notably, if the broker-dealer or associated person makes the point-of-sale disclosure *orally*, they are nevertheless required to make and preserve a record of such disclosure among their business records.⁹ Thus, current federal point-of-sale disclosure requirements contemplate oral disclosure, but also require the creation of a written record.

2. In June 2013, the Division dramatically revised and expanded the scope of the original Rule without adequate explanation or notice of why the Rule was expanded to apply to all transactions, and not limited to penny stock transactions as originally drafted.

On June 3, 2013, the Division published a major change to the Rule, by moving Section E(6)(a) to Section A(32), and by eliminating the Rule's narrow limitation to *"sale[s] of OTC (over the counter) unlisted non-NASDAQ equity securities."* As amended, the Rule now extends the disclosure requirements to *all* transactions in *all* securities, whether listed or unlisted, whether equity, debt, or otherwise. The Virginia regulatory notice (Volume 29, Issue 20, effective June 3, 2013), however, gave

⁴ We also note that the Rule's point-of-sale disclosure requirements continue to impose undue burdens and regulatory risks on securities firms that do business in Virginia, because they differ from and are in addition to federal standards and the laws of every other State.

⁵ Virginia Register of Regulations, Volume 29, Issue 20, June 3, 2013, available at: <http://register.dls.virginia.gov/vol29/iss20%5Cv29i20.pdf>, at p. 2482.

⁶ *Id.* at pp. 2481 – 2482.

⁷ *Id.* at pp. 2482.

⁸ 17 CFR §§ 240.15g-4 and 15g-5.

⁹ *Id.* at §§ 240.15g-4(b)(2) and 15g-5(b)(2).

no notice of, or explanation for, the massive expansion of the scope of the Rule.¹⁰ Because the regulatory notice gave no indication that the Rule was being expanded to apply to all transactions, commenters were not given the opportunity to address such an expansion in their comments, as they certainly would have done if put on notice.

3. Virginia has long-recognized NSMIA preemption with respect to SEC record making and keeping obligations.

Section 103 of NSMIA amended Section 15 of the Exchange Act to expressly preempt states from enacting regulations relating to making and keeping records “*that differ from, or are in addition to, the requirements in those areas established under [the Exchange Act]*.”¹¹ In July 2003, the Division recognized this explicit preemption when it amended its own books and records rule, 21 VAC 5-20-240, to conform to the books and records requirements established by the SEC. The Summary to the rule change states, “[*The Virginia books and records rule*] was substantially revised to adopt the new federal Securities and Exchange Commission books and records requirements. By federal law, states may not have books and records requirements that are in addition to those required by the federal SEC.”¹²

4. The Rule’s point-of-sale disclosure requirement creates a books and records requirement preempted by NSMIA.

As a practical matter, in order to monitor compliance with, and ensure adequate supervision over, the Rule’s point-of-sale disclosure requirements, firms would necessarily need to document in writing (to the extent the disclosure was made orally) whether the disclosure was made and the substance of the disclosure. As a legal matter, Exchange Act Rule 17(a)-4 requires member firms to keep a record of “*all communications ... by the member ... relating to its business as such....*”¹³

Both prior to and following its amendment, the Rule imposes communications requirements on firms “relating to its business as such” which in turn trigger record-making and keeping obligations under SEC rules. As originally drafted, the Rule’s point-of-sale disclosure requirements did not present a NSMIA preemption issue because the limited record-keeping obligations that it triggered were the same as the recordkeeping obligations set forth in Exchange Act Rules 15g-4 and 15g-5 (discussed above).

As amended, however, the Rule dramatically expands the range of communications a firm must make relating to its business as such. Consequently, the Rule also thereby dramatically expands the recordkeeping obligations of the firm relating to those communications. By expanding the firm’s communications relating to its business as such, the Rule also thereby creates new recordkeeping

¹⁰ Virginia Register of Regulations, Volume 29, Issue 20, June 3, 2013, available at: <http://register.dls.virginia.gov/vol29/iss20%5Cv29i20.pdf>, at pp. 2464 – 2468.

¹¹ 15 U.S.C. §78o(i)(1).

¹² Virginia Register of Regulations, Volume 19, Issue 23, July 1, 2003, available at: <http://register.dls.virginia.gov/vol19/iss23/v19i23.pdf>, at p. 3372.

¹³ 17 CFR §§ 240.17a-4(b)(4).

obligations that differ from and are in addition to those established under the Exchange Act. The central purpose of the NSMIA preemption provision was to ensure uniform and consistent record-keeping obligations across the fifty States, as established by the SEC. The Rule directly undercuts that purpose and is thus, preempted by NSMIA.

5. The Rule should be amended to conform to the federal rules governing penny stock transactions.

Based on the foregoing, we recommend that the Rule should be amended to conform to Exchange Act Rules 15g-4 and 15g-5, as follows:

“No broker-dealer who is registered or required to be registered shall:

(32) Effect a transaction in any penny stock for or with the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (a) of this section, the aggregate amount of any compensation received by such broker or dealer in connection with such transaction.

(a) Timing. The disclosure: (i) shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and (ii) shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to Exchange Act Rule 10b-10.

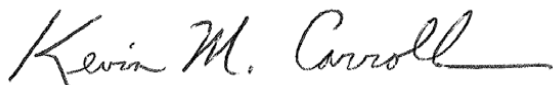
(b) Record. A broker or dealer, at the time of making the disclosure pursuant to paragraph (a)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in Exchange Act Rule 17a-4(b).

(c) Exempt Transactions. The transactions set forth in Exchange Act Rule 15g-1 shall be exempt from the requirements of this section.”

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If you have questions, or would like to further discuss this matter, please contact Kevin Carroll at 202.962.7382 or kcarroll@sifma.org, or Nancy Lancia at 212.313.1233 or nlancia@sifma.org.

Sincerely,



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