Small Investments, Big Losses: The States' Role in Protecting Local Investors from Securities Fraud

Carlos Berkejó

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SMALL INVESTMENTS, BIG LOSSES: THE STATES’ ROLE IN PROTECTING LOCAL INVESTORS FROM SECURITIES FRAUD

Carlos Berdejo*

Abstract: The securities regulation landscape has changed dramatically in recent years. Federal laws have increasingly preempted the regulatory power of states, while at the same time expanding the universe of securities offerings that are not subject to registration at the federal level. These political and policy choices reflect a balancing of two sometimes competing goals: protecting investors and facilitating capital formation. While policies centered on preemption and deregulation might reduce the cost of raising capital, these could also lead to more pervasive securities fraud. Any resulting increase in fraudulent practices is likely to disproportionately affect small securities offerings that are local in nature, for which the deterrent effect of private securities litigation and public enforcement is weaker. This places unsophisticated and non-wealthy investors, those less capable to absorb financial losses, at a disproportionate risk of fraud. From a broader economic perspective, the social welfare implications of such fraudulent securities offerings may be significant even when the amounts involved in each individual transaction appear to be relatively trivial to the casual observer.

This Article identifies and theorizes the under-regulation of small-scale securities transactions that results from the confluence of federal preemption and the weakness of traditional enforcement mechanisms that are better suited to large-scale fraud. This Article is also the first to identify and analyze the economic and policy implications of two existing and potential trends in state regulation that might mitigate this state of affairs. In the last two decades, a growing number of states have broadened the remedies available to their securities commissioners in administrative actions to include the ability to request or order restitution on behalf of injured investors. The second trend is at a more nascent stage. Recently, some states have experimented with public insurance-type schemes that allow defrauded investors to recover a portion of their losses. The renewed emphasis on compensating victims of fraud highlighted by these developments is encouraging, but more states should follow suit. To that end, this Article makes a series of normative suggestions to improve the effectiveness of these state legislative responses and to promote their more widespread adoption.

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INTRODUCTION

On March 30, 2007, the following advertisement appeared in the classified section of the Missoulian under the heading “Investments”:

24% well-secured fixed 1 yr. yield w/ Go Zone trusts.
Help rebuild booming Gulf Coasts. Terry, [phone number].

Attracted by the prospects of a twenty-four percent return, Rece Cobeen, a resident of Montana, responded to the ad and contacted Terry Parks. Between April 19, 2007, and July 15, 2008, Cobeen invested a total of $55,000, most of his life savings, in exchange for notes. The notes were not registered with any state or federal agency and Parks never provided Cobeen with any type of written disclosure document relating to the notes or Parks’s activities. After July 2008, Cobeen had become suspicious of Parks’s motives and the extraordinarily high interest rate that he had been promised. Cobeen contacted Parks and asked for his money back, but Parks refused to return the money and subsequently relocated to Texas.

What could Cobeen do at this point? A natural response is that he should look to the federal securities laws, namely the 1933 Securities Act (Securities Act) and the 1934 Exchange Act (Exchange Act), that employ various devices to protect investors from fraudulent offerings. For example, the registration requirements of the Securities Act mandate the disclosure of information to investors prior to the sale of securities.

3. Id.
5. Parks, 310 P.3d at 1090–91.
6. Id. Cobeen had only received a $400 interest payment on June 2007. Id.
7. Id.
11. See infra section I.A.
12. See infra notes 39–40 and accompanying text.
Those who fail to meet these registration requirements or commit fraud in the materials provided to investors face liability under the Act’s investor-friendly civil liability provisions.\(^{13}\)

But not all securities transactions are created equal. Although the federal securities laws apply to all offers and sales of securities, the extent of regulation varies from transaction to transaction. Certain offerings are exempt from the registration requirements of the Securities Act, leaving investors with fewer protections against opportunistic promoters.\(^{14}\) As it turns out, many of these exemptions cover small and local offerings, which present a disproportionate risk of failure and fraud.\(^{15}\) Complicating matters further for investors like Cobeen, there has been a persistent trend towards increasing the number and expanding the scope of these exemptions.\(^{16}\) But even if Cobeen’s transaction was exempt from registration, Rule 10b-5 of the Exchange Act would likely afford him some protection. Rule 10b-5, the catch-all antifraud provision, applies to all securities transactions, whether or not they are exempt from the registration requirements of the Securities Act.\(^{17}\)

Determining whether he has a valid cause of action under the federal securities laws would be just part of Cobeen’s calculus. Bringing a lawsuit is a costly and risky proposition: not only would Cobeen have to spend additional resources in attorney fees, but he would face the prospect of losing the lawsuit or being unable to enforce and recover a judgment against Parks.\(^{18}\) This, of course, is a predicament faced by all defrauded investors, and various mechanisms, such as contingency fees, class actions, and public enforcement by the Securities and Exchange Commission (SEC), have developed in response.\(^{19}\) Unfortunately for Cobeen, these mechanisms often do not work well for small, local transactions. Although $55,000 certainly is a substantial amount of money for Cobeen, it likely is not large enough to make it economically practical for the SEC or a private plaintiff’s attorney to pursue an action.\(^{20}\)

Cobeen could also explore state securities laws that may afford him protection. Registration and information disclosure requirements provide

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13. See infra notes 41–42 and accompanying text.
14. See infra notes 43–52 and accompanying text.
15. See infra note 61 and accompanying text.
16. See infra notes 53–57 and accompanying text.
17. See infra notes 62–64 and accompanying text.
18. See infra notes 68–69 and accompanying text.
19. See infra notes 70–71 and accompanying text.
20. See infra notes 102–04 and accompanying text.
an *ex ante* mechanism to weed-out, or at least alert investors to, fraudulent offerings.\(^{21}\) However, the prophylactic effect of these provisions has been blunted by federal law, which has increasingly preempted state registration requirements for certain offerings that are exempt from federal registration, leaving investors with fewer *ex ante* regulatory protections.\(^{22}\) State securities laws also contain anti-fraud provisions that mirror their federal counterparts.\(^{23}\) But even if Cobeen had a claim under state law, he would still face the costs and risk associated with pursuing his claim in court and enforcing his judgment were he to prevail.

Cobeen ultimately filed a complaint with the Montana Commissioner of Securities and Insurance, who then filed an action against Parks for securities fraud and selling securities without registration.\(^{24}\) In October 2011, a jury found Parks guilty and the judge imposed a ten-year sentence.\(^{25}\) From society’s perspective, this outcome is desirable, as it provides more power to the deterrent effects of the securities laws and discourages future fraudulent activities. But what could motivate Cobeen to file a complaint with the securities commissioner and cooperate with the investigation and trial, admitting publicly that he was taken advantage of in such manner? Having Parks sentenced to ten years of imprisonment may provide a sense of retribution for Cobeen, but it does not compensate him for his substantial monetary loss. In fact, with Parks imprisoned and unable to work, recovery in a civil action becomes an even more unlikely prospect.

As it turns out, Montana law allows the state securities administrator to request the court to grant an order of restitution on behalf of defrauded investors.\(^{26}\) So, in addition to the ten-year prison term, the judge also ordered restitution—i.e., that Parks return to Cobeen the balance of his $55,000 investment.\(^{27}\) This result highlights a recent trend in securities regulation and the protection of small investors at the state level. A growing number of states have expanded the authority of their state securities administrators, authorizing them to request that a court grant restitution in favor of an injured investor even in civil actions

\(^{21}\) See *infra* notes 106–08 and accompanying text.
\(^{22}\) See *infra* notes 115–17 and accompanying text.
\(^{23}\) See *infra* note 109 and accompanying text.
\(^{25}\) Id. at 1092–93.
brought by administrators.28 Many states have gone further and have authorized their securities administrators to order restitution as part of an administrative action.29 These regulatory innovations increase both the deterrent effect of state law and the likelihood of injured investors receiving some compensation for their losses.

Unfortunately, the court-ordered restitution appeared to be of little value to Cobeen, as Parks had spent all of Cobeen’s money and was to be incarcerated for the near future, making payment of the $55,000 nearly impossible. Once again, Cobeen benefitted from a recent innovation in states’ securities regulation. Cobeen was able to receive $13,750 (twenty-five percent of his losses) from the Montana Securities Restitution Assistance Fund, an insurance-type fund that had been established a few years earlier to assist victims of securities fraud who otherwise have no opportunity to receive restitution.30

Cobeen’s story illustrates how the traditional enforcement mechanisms associated with federal securities regulation, which rely heavily on the SEC and private class action litigation, neglect a significant subset of transactions, namely small and local ones. Because registration is the preeminent mechanism for investor protection, the tilt towards exempting small-scale securities from registration requirements has created regulatory lacunae in which small investors are at great risk. Federal preemption can exacerbate this problem by preventing states from stepping into the breach and regulating the distribution and sale of securities.

This under-regulation of small-scale securities transactions, which results from the confluence of federal preemption and existing civil remedies that are better suited to address large-scale fraud, is a symptom of a normative conflict between state and federal securities laws. State securities laws are “remedial in character, designed to prevent frauds and impositions upon the public,” and are generally liberally construed to protect investors.31 The federal securities laws, on the other hand, must balance the goal of protecting investors with the broader goals of maintaining the integrity of the national capital markets and facilitating

28. See infra notes 145–47 and accompanying text.
29. See infra notes 148–63 and accompanying text.
30. See Press Release, supra note 4; infra section II.B.1.b.
capital formation.\textsuperscript{32} For cases of securities fraud that are national in scope, the allocation of power between the federal government and the states does not cause major problems. However, when it comes to cases involving small, local fraud, the preeminence of federal regulation often results in a system that can be highly dysfunctional.

Although the amounts involved in these transactions may appear trivial (relative to the more salient cases that are of interest to the SEC, plaintiff’s attorneys, and the financial press), the individual losses may be in fact quite significant, especially if these involve a large percentage of the victim’s wealth.\textsuperscript{33} Thus, the social welfare implications of these small, but numerous, instances of fraud can be substantial and merit the attention of policy-makers. Regulation and enforcement at the state level arguably provides a superior toolset to maintain adequate deterrence and ensure a base level of compensation for victims in these types of transactions. However, since the power of the states to regulate the distribution and sale of securities \textit{ex ante} has been significantly curtailed by federal legislation preempting state law, states have increasingly focused their efforts on \textit{ex post} mechanisms to regulate these transactions.

This Article identifies and analyzes the economic and policy implications of two important trends in state regulation and enforcement that have developed in response to the under-regulation problem described above. In the last two decades, a growing number of states have broadened the remedies available to their securities commissioners in administrative actions to include the ability to request or order restitution on behalf of injured investors.\textsuperscript{34} Although this expansion of


\textsuperscript{33} And when considered in the aggregate, the amounts involved in these small transactions can be quite large. Although each individual offering may be small, the market for private, exempt securities offerings dwarfs the market for public, registered offerings. In 2014, $2.1 trillion was raised in 35,637 private placements. Registered offerings, on the other hand, accounted for $1.35 trillion of new capital, raised in 2,752 offerings. See SCOTT BAUGuess ET AL., CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009–2014, at 6–7 (2015), https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf [https://perma.cc/U3F6-JD6R].

\textsuperscript{34} See \textit{infra} section II.A.
administrative power enhances the deterrent effect of securities laws and facilitates compensation for injured investors, concerns relating to increased costs and procedural fairness are likely preventing broader adoption. This Article argues that further cooperation and coordination among states could help address these concerns and encourage more states to authorize their administrators to order restitution. The second innovation is more recent. A few states have begun to experiment with insurance-type schemes that offer defrauded investors partial compensation for losses suffered as a result of securities violations.\(^{35}\) These newly established restitution funds are promising, but the design of these programs should carefully consider likely behavioral responses by investors and administrators to ensure their success. This Article presents a series of recommendations to address these concerns and increase the likelihood that other states will establish their own restitution funds.

More generally, this Article contributes to a number of important debates in the academic literature. First, it opens new avenues in longstanding policy discussions over the basic tension between protecting investors and facilitating capital formation, two fundamental goals of securities regulation.\(^{36}\) Second, by providing a theoretical framework to assess the involvement of local governments in the regulation of securities, this Article adds a new dimension to the literature weighing the optimal allocation of regulatory power among federal and state governments in a multijurisdictional framework.\(^{37}\) Finally, this Article is part of a growing literature evaluating large-scale compensation efforts by administrative agencies and other public actors.\(^{38}\)

This Article proceeds as follows. Part I discusses the role of federal and state law in the regulation of the securities markets, highlighting the precarious position occupied by victims of small-scale fraud in this multi-jurisdictional framework. Part II examines and assesses the two recent innovations of the states in their struggle against securities fraud described above, underscoring their relationship to two interconnected goals of securities regulation: deterrence and compensation. Part III discusses the general implications of these developments and concludes.

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35. See infra section II.B.
36. See supra notes 31–32 and accompanying text.
37. See infra section I.B.1.
38. See infra note 172 and accompanying text.
I. THE CHANGING LANDSCAPE OF SECURITIES REGULATION

This section begins with an overview of the federal regulation of securities markets, highlighting how small-scale fraud is unlikely to be pursued by public or private enforcement of federal law. The second part of this section focuses on state regulation and, in particular, the role of state administrators in regulating local securities markets and enforcing states’ securities laws, a topic that has received limited attention in the academic literature.

A. Federal Regulation of the Securities Markets

The federal securities laws provide a wide array of measures to protect investors. Under the regulatory framework of the Securities Act, an issuer selling securities must prepare a set of mandatory disclosure documents, including a registration statement, which must be filed with the SEC, and a prospectus, which is part of the registration statement and must be distributed to the investors. A sale of unregistered securities gives rise to Section 12(a)(1) liability, which grants investors rescissory rights if the securities were offered or sold in violation of the Securities Act’s registration requirements. In addition to mandating the disclosure of information, the Securities Act contains two civil liability provisions that protect investors in the event that the information contained in these disclosure documents is fraudulent. Section 11 of the Securities Act imposes liability if the registration statement contains a material misrepresentation, while Section 12(a)(2) provides a cause of action for material misstatements contained in the prospectus.

39. The Securities Act, 15 U.S.C. §§ 77a–77z (2012), which governs the primary public offerings of securities by issuers, provides that, unless otherwise exempt, all offers and sales of securities must be registered with the SEC. See THOMAS LEE HAZEN, FEDERAL SECURITIES LAW 2–3 (Kris Markarian ed., 3d ed. 2011). An issuer may not offer securities to the public unless a registration statement has been filed with the SEC and sales of such securities cannot be completed until the registration statement is declared effective by the SEC. 15 U.S.C. §§ 77e(a)–(c); see generally Joan MacLeod Heminway & Shelden Ryan Hoffman, Proceed at Your Peril: Crowdfunding and the Securities Act of 1933, 78 TENN. L. REV. 879, 907 (2011) (noting broad sweep of Section 5 of the Securities Act); STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 393–401 (Robert C. Clark et al. eds., 3d. ed. 2012) (describing the public offering process).


42. 15 U.S.C. § 77l(a)(2). Although the term prospectus can be broadly construed, Section 12(a)(2) is limited to public offerings of securities. See Gustafson v. Alloyd Co., 513 U.S. 561, 584
To avoid the costs associated with being subject to the registration requirements of the Securities Act (and its accompanying civil liability provisions), an issuer must structure the sales of securities to fit within an exemption. For example, Section 3(a)(11) of the Securities Act provides a statutory exemption from registration for securities offered and sold to persons residing in a single state by an issuer incorporated in and doing business in that same state. Another, better-known statutory exemption from registration is found in Section 4(a)(2), which exempts “transactions by an issuer not involving any public offering.” Since the statute does not explicitly define “public offering,” this term has been construed by the SEC and federal courts as offerings involving investors who are not “able to fend for themselves.”

To provide additional clarity and predictability in the use of Section 4(a)(2)’s private placement exemption, the SEC promulgated Regulation D. Rule 506 of Regulation D provides a safe harbor based on Section 4(a)(2)’s private placement exemption, which allows an issuer to offer and sell, without registration, an unlimited aggregate principal amount of securities to any number of “accredited investors” so long as certain conditions are met. A Rule 506 offering may include up to thirty-five

(1995) (defining the term “prospectus” as “a document that describes a public offering of securities”).

43. The rationale behind these exemptions is that the registration safeguards may not be necessary in certain situations. See H.R. Rep. No. 73-85, at 5 (1933) (noting the inefficiency of requiring registration “where there is no practical need for [application of the Securities Act] or where the public benefits are too remote”); C. Edward Fletcher, III, Sophisticated Investors Under the Federal Securities Laws, 1988 DUKE L.J. 1081, 1133 (1988) (“As a historical matter, Congress did not design the securities laws to protect investors capable of protecting themselves.”).

44. 15 U.S.C. § 77c(a)(11). Generally, an offering qualifies as an “intrastate offering” if it involves local investors, local companies, and local financing. See Section 3(a)(11) Exemption for Local Offerings, Securities Act Release No. 33-4434 (Dec. 6, 1961). Historically, the SEC and the courts have construed this exemption very narrowly, so issuers trying to rely on this exemption avail themselves of the Rule 147 safe harbor. See CHOI & Pritchard, supra note 39, at 583–85. An offering that meets the requirements of Rule 147 is deemed to qualify for the section 3(a)(11) intrastate offering exemption. 17 C.F.R. § 230.147 (2015).


46. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). The Supreme Court held that the applicability of this exemption “should turn on whether the particular class of persons affected need the protection of the [Securities] Act,” which is designed “to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.” Id. at 124–25.


48. 17 C.F.R. § 230.506(a), (c). The definition of “accredited investor” includes certain institutional investors, such as banks and insurance companies, individuals with a net worth over $1 million (excluding the investor’s primary residence) or annual income over $200,000 for the previous two years, private business development companies, certain trusts and business
investors that are non-accredited, so long as they are able to evaluate the potential gains and risks associated with the investment and the issuer refrains from engaging in general solicitation.\(^{49}\) Another set of exemptions contained in Regulation D, Rule 504\(^{50}\) (which exempts offerings under $1 million) and Rule 505\(^{51}\) (which exempts offerings under $5 million), are based on Section 3(b)(1) of the Securities Act, which grants the SEC rulemaking authority to exempt offerings involving $5 million or less from the Act’s registration requirements.\(^{52}\)

In recent years, Congress has sought to further facilitate the ability of issuers to offer and sell securities without registration by increasing the availability and scope of exemptions. The Jumpstart Our Business Startups Act (JOBS Act)\(^{53}\) amended the Securities Act by adding Section 3(b)(2) and directing the SEC to update and expand the Regulation A exemption to allow offerings of up to $50 million, a substantial increase from the pre-existing $5 million cap.\(^{54}\) The SEC adopted the new Regulation A rules in June 2015.\(^{55}\) The JOBS Act also added Section 4(a)(6) to the Securities Act, creating a new exemption from registration for a type of capital raising known as “crowdfunding,” which uses the

organizations with assets exceeding $5 million, and directors, executive officers or general partners of the issuer. 17 C.F.R. § 230.501(a)(1)–(6).


50. 17 C.F.R. § 230.504.

51. Id. § 230.505.


54. JOBS Act § 401. Regulation A was originally promulgated by the SEC under its Section 3(b) authority to exempt smaller offerings of up to $5 million. However, the exemption was rarely used, with only nineteen qualified Regulation A offerings from 2009 to 2012 for a total offering amount of $73 million. See Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, Securities Act Release No. 33-9497, at 11 (Dec. 18, 2013). By comparison, during the same time period, there were approximately 27,500 offerings of up to $5 million that were conducted under one of the Regulation D exemptions, with a total offering amount of approximately $25 billion. Id. Under the new Section 3(b)(2) exemption, an issuer may offer and sell up to $50 million in securities within a twelve-month period. 15 U.S.C. § 77c(b)(2).

55. As adopted, Regulation A+ provides for two tiers of offerings: Tier 1, for offerings of securities of up to $20 million, and Tier 2, for offerings of securities of up to $50 million. Both tiers are subject to certain basic eligibility requirements, while Tier 2 offerings are also subject to additional disclosure and ongoing reporting requirements, including a requirement to provide audited financial statements and file periodic reports. See Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Securities Act Release No. 33-9741, at 7 (Mar. 25, 2015).
internet to pool small individual contributions.\textsuperscript{56} The SEC promulgated the crowdfunding rules in May 2016.\textsuperscript{57}

Although exemptions from registration seek to lower the cost of capital, there are risks associated with the accompanying reduction in the amount of information that issuers must disclose to investors as part of the offering process.\textsuperscript{58} Exempting small offerings from registration thus reflects a policy tradeoff.\textsuperscript{59} On one hand, the social benefits of forcing disclosure requirements upon small issuers appear less significant given the minimal role these companies play in the secondary markets and in the economy in general, while the compliance costs incurred by these issuers are likely high.\textsuperscript{60} On the other hand, to the extent that smaller companies present a disproportionate risk of failure and fraud, expanding exemptions from the registration requirements for these issuers could be particularly problematic, as it places investors at an increased risk.\textsuperscript{61}

For investors purchasing securities in offerings that are exempt from registration, the civil liability provisions of the Securities Act, namely Sections 11 and 12(a)(2), are unavailable. These investors, however, may still bring a cause of action under Section 10(b) of the Exchange Act\textsuperscript{62} and its implementing rule, Rule 10b-5, which generally prohibits fraud and deceptive practices “in connection with the purchase or sale of

\begin{itemize}
\item \textsuperscript{56} JOBS Act §§ 301–02.
\item \textsuperscript{57} Crowdfunding, Securities Act Release No. 33-9974, at 1 (Oct. 30, 2015).
\item \textsuperscript{59} See, e.g., Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the Comm. on Banking, Hous., & Urban Affairs, 112th Cong. 2 (2011) (statement of John C. Coates IV, Professor of Law and Economics, Harvard Law School), http://www.banking.senate.gov/public/_cache/files/1d24b42c-3e88-46f8-bf86-9c4764faffa33a80 9ff535d9925b69836a6e068fd0.coastestimony121411.pdf [https://perma.cc/6TJN-AEGG] (noting “the balance that existing securities laws and regulations have struck between the transaction costs of raising capital . . . and the combined costs of fraud risk and asymmetric and unverifiable information” (emphasis in original)).
\item \textsuperscript{60} See Carlos Berdejo, Going Public After the JOBS Act, 76 OHIO ST. L.J. 1, 18–19 (2015) (arguing that the optimality of mandating registration on a particular set of issuers depends on the relative benefits and costs associated with the mandated disclosures); Michael D. Guttenberg, Accuracy Enhancement, Agency Costs, and Disclosure Regulation, 3 REV. L. AND ECON. 611, 625–27 (2007) (arguing that requiring disclosure for larger firms may be efficient and socially desirable).
\item \textsuperscript{61} See Jill E. Fisch, Can Internet Offerings Bridge the Small Business Capital Barrier?, 2 J. SMALL & EMERGING BUS. L. 57, 58 (1998) (“[R]egulators have identified small businesses as some of the riskiest investment opportunities.”).
\end{itemize}
any security.” Although the scope of the Rule 10b-5 appears to be broader, a cause of action under this provision is more complicated for plaintiffs relative to a Section 11 or Section 12(a)(2) claim.

1. Private Enforcement of Federal Laws

The causes of action available to an investor who has been defrauded in a securities transaction will depend on whether the transaction in question was exempt from the Securities Act’s registration requirements. If the transaction was exempt from registration, then an investor could have a Rule 10b-5 cause of action. If the transaction was not exempt from registration and there was no effective registration statement covering the securities, then in addition to the Rule 10b-5 claim, an investor will be able to pursue the more straightforward Section 12(a)(1) and rescind the transaction. Finally, if the transaction is not exempt from registration and the offering was registered, in addition to the Rule 10b-5 claim, the investor may also have a Section 11 or Section 12(a)(2) claim.

But investors who have a valid claim under the securities laws will not necessarily bring a lawsuit to assert their rights. From an investor’s perspective, pursuing a claim in court can in itself be quite a risky proposition. The fixed costs of bringing a lawsuit can be large, and a single investor may not have the resources or economic incentives to pursue a claim. If the investor does not prevail in court, not only will

64. To prevail in a Rule 10b-5 claim, an investor must establish a number of elements, including a material misrepresentation or omission, scienter, reliance, and loss causation. See Erica P. JohnFund, Inc. v. Halliburton Co., 563 U.S. 804, 809–10 (2011). On the other hand, to succeed in a Section 11 or 12(a)(2) claim, a plaintiff only need establish the existence of a material misrepresentation in the registration statement or prospectus. See supra notes 41–42 and accompanying text.
65. See supra notes 62–64 and accompanying text.
66. See supra note 40 and accompanying text. Selling securities without a registration statement being in effect is a violation of Section 5(a), thus giving rise to a Section 12(a)(1) claim. See supra note 39. This Section 12(a)(1) cause of action is independent of any potential fraudulent statement made by the seller. See supra notes 41–42.
67. See supra notes 41–42 and accompanying text.
68. This follows if we model a plaintiff’s decision to pursue a civil action as a weighing of the costs of bringing a lawsuit and the amount of money the plaintiff expects to recover from defendants. For an example of such a model, see A. Mitchell Polinsky, Private versus Public Enforcement of Fines, 9 J. LEGAL STUD. 105, 107 (1980). For a numerical example of how litigation costs provide a disincentive to plaintiffs from filing civil suits if the amount of recovery does not exceed the associated costs, see Alex Stein and Gideon Parchomovsky, Empowering Individual Plaintiffs 4 (Sept. 2016) (unpublished manuscript) (on file with University of Pennsylvania Law School Legal Scholarship Repository), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article
the investor not be compensated for their original loss, but they will also have spent additional resources. And even if the investor prevails, enforcing a judgment may be extremely costly if, for example, the defendant is bankrupt, has no assets to attach, or has otherwise absconded. Arguably, the costs and risks associated with bringing a lawsuit are likely to present a more formidable barrier to investors who have suffered relatively small losses.

The solution to this investor dilemma lies in the contingency fee and class action mechanisms. Class actions, in which an attorney represents a group of similarly harmed investors, can effectively spread the costs associated with securities litigation, thus making it economically feasible for injured investors to bring their claims in court. Moreover, since attorneys representing a class are often compensated only if the class wins (i.e., by a contingency fee), class actions also reduce the risk of bringing a lawsuit by protecting investors from additional losses in the event that the lawsuit is dismissed or otherwise fails. The merits of the securities class action mechanism and its effectiveness in deterring fraud and compensating its victims have been highly debated in the


71. See James J. Park, Rules, Principles, and the Competition to Enforce the Securities Laws, 100 CAL. L. REV. 115, 159 (2012) (noting that class action attorneys are willing to invest resources as they are motivated by the possibility of a large contingency fee).
What is certainly less controversial is the proposition that smaller issuers are relatively immune to class actions, significantly reducing any deterrence or compensation value of such mechanism.\(^7^{3}\)

The structure of attorney compensation in class actions renders these ineffective in the context of small-scale fraud, which results in a skewed composition of securities fraud class actions favoring cases involving larger-scale fraud.\(^7^{4}\) Securities class actions in federal court involve fraud by large companies whose securities trade in the national stock exchanges (and are less likely to be judgment proof); not surprisingly, these class actions relate to frauds that are large in magnitude (which correlates with the compensation of plaintiffs’ attorneys).\(^7^{5}\) In cases where the aggregate amounts involved are small, the loss suffered by the potential plaintiffs may not be sufficiently high to attract the interest of a

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72. See James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 979 (1996) (“[E]mpirical results show that most securities-fraud class actions are, in fact, frivolous.”); Choi, supra note 70, at 1477–98 (reviewing prior studies suggesting securities class actions were often nonmeritorious); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545 (2006) (citing empirical evidence that settlements recover only a very small share of investor losses and concluding that “[f]rom a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly”); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Enforcers*, 85 VA. L. REV. 925, 947–50 (1999) (arguing that “securities class actions are an expensive way to reduce the social costs of fraud” and are “susceptible to over-reaching by plaintiffs’ attorneys, which means that shareholders may receive only a small percentage of their recoverable damages”).

73. See Coffee, supra note 72, at 1543 (“[T]he conventional wisdom has long been that companies with small market capitalizations are less likely to be sued in securities class actions.”); Bohn & Choi, supra note 72, at 936 (concluding that “smaller sized offerings hardly ever experience a securities-fraud suit”).

74. See Pritchard, supra note 72, at 951–52 (“The contingent percentage fee also discourages plaintiffs’ lawyers from bringing suit in cases where the damage recovery will be too small to justify their fees, even if the evidence of fraud is strong. For this reason, companies with small capitalizations or trading volume may be effectively immune from the threat of a class action suit.”); Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 239 (2007) (noting that small firms are less likely to be sued because of attorney incentives given that “the potential recovery in a class action lawsuit involving a large firm with actively traded shares is likely to exceed the recovery in a case involving a small firm with thinly traded stock”); Coffee, supra note 72, at 1543 (noting that because attorney fees are related to the size of recovery, small market capitalization companies are less likely to be sued).

75. On average, 189 securities class actions were filed in federal court each year during the period 1997–2013, of which 172 involved securities trading in the New York Stock Exchange or Nasdaq. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2014 YEAR IN REVIEW 4, 24 (2015), http://securities.stanford.edu/research-reports/1996-2014/Cornerstone-Research-Securities-Class-Action-Filings-2014-YIR.pdf [https://perma.cc/QWM8-JHW7]. The average change in defendants’ market capitalization between the trading day immediately preceding the beginning of the class period and the trading day immediately following the end of the class period was $124 billion. Id. at 6.
plaintiff’s attorney. Although the precise threshold of what defines a small company or offering is not evident, it certainly is higher than the one for the type of small, localized fraud considered in this Article.

2. Public Enforcement of Federal Laws

The public sector, led by the SEC, also plays a critical role in enforcing securities laws. In those cases it chooses to pursue, the SEC may bring a civil enforcement action in federal court or commence an administrative proceeding. Contested administrative proceedings are heard by one of five SEC-appointed judges. When determining in which forum to bring a case, the SEC considers a series of factors, including the costs and expected duration of the proceedings in each venue.

From the SEC’s perspective, administrative actions present a number of advantages over civil suits in federal court. First, administrative actions are handled internally and entail more expedient proceedings with less exacting evidentiary requirements, which allows the SEC to prosecute a greater number of cases given its budgetary constraints.


77. See, e.g., Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 STAN. L. REV. 497, 511–13 (1991) (finding that none of the initial public offerings (IPOs) in the early 1980s that had market losses under $20 million resulted in litigation); Bohn & Choi, supra note 72, at 926–37 (finding that during the period 1975–1986 less than one percent of IPOs with an offering amount of less than $5 million resulted in a securities class action).


82. See Cox, Thomas & Kiku, supra note 76, at 749 (presenting evidence that the SEC has “a strong preference for administrative enforcement actions”).

83. See Jean Eaglesham, SEC Fights Challenges to Its In-House Courts, WALL ST. J. (June 21, 2015, 7:06 PM), http://on.wsj.com/1QpBtAK (last visited Apr. 17, 2017); Eaglesham, SEC Is Steering More Trials to Judges It Appoints, supra note 80 (noting that rulings in administrative
Second, because the administrative judges who preside over these administrative actions have special knowledge of the securities laws and industry, the fact-finding process can be more streamlined and sophisticated. Historically, however, administrative actions did suffer a number of significant limitations relative to civil court actions—restrictions on the class of defendant, the type of remedies, and the range of options regarding what to do with the funds recovered from a defendant. These limitations made administrative actions less attractive relative to civil actions.

Historically, the ability of the SEC to obtain monetary remedies as a result of an administrative proceeding was quite limited. Prior to 1990, the SEC could only impose civil penalties in cases involving insider trading and certain violations of the Foreign Corrupt Practices Act, and it lacked the authority to order disgorgement. To obtain monetary relief, the SEC had to bring a civil action and ask the court to exercise its equitable powers and order an “ancillary relief.” In 1990, Congress substantially expanded the range of remedies that the SEC could pursue administratively, granting the SEC the power to obtain the disgorgement of ill-gotten gains and civil penalties. But even after the 1990 proceedings are usually handed down within 300 days of the case being filed, compared to years for the typical federal-court case).

84. See Eaglesham, SEC Is Steering More Trials to Judges It Appoints, supra note 80 (quoting the SEC enforcement chief as saying: “[w]e’re using administrative proceedings more extensively because they offer a streamlined process with sophisticated fact finders”). However, the specialized expertise of these judges is an open question. See Jean Eaglesham, U.S. Chamber of Commerce Criticizes SEC’s In-House Court, WALL ST. J. (July 15, 2015, 12:01 AM), http://on.wsj.com/1qpcJnn (last visited Apr. 17, 2017) (citing a U.S. Chamber of Commerce report that states that during the last thirty years, the SEC “has not hired a single [administrative law judge] who had directly relevant experience or expertise related to the federal securities laws”).

85. For a summary of the historical development surrounding SEC administrative actions and a description of the main differences between administrative and civil proceedings involving the SEC, see Urska Velikonja, Are the SEC’s Administrative Law Judges Biased? An Empirical Investigation, 92 WASH. L. REV. 315, 324–27 (2017).


88. Id. at 339–40.

89. See Velikonja, supra note 87, at 341; U.S. SEC. AND EXCH. COMM’N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002, at 33 (2003), http://www.sec.gov/news/studies/sox308creport.pdf [https://perma.cc/CA2V-X4MT] [hereinafter 308(C) REPORT]. To order disgorgement, the SEC has to show that the defendant profited from the securities violation, not just that the investor lost money due to the fraud. See SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) (“The purpose of disgorgement is to force ‘a defendant to give up the amount by which he was unjustly enriched’ rather than to compensate the victims of fraud.” (quoting SEC v.
reforms, the SEC could only impose civil fines in an administrative proceeding in actions involving regulated entities, such as broker-dealers and investment advisors; for other entities, the SEC still needed to pursue the case in federal court and request that the court order the defendant to pay a civil fine.91 The Dodd-Frank Act of 2010 further expanded the SEC’s authority to impose civil fines in administrative proceedings against any entity or person.92 Anecdotal evidence suggests that the SEC has since brought an increasing number of enforcement actions administratively rather than in federal court.93 For example, in 2014, the SEC brought more than four out of five of its enforcement actions as administrative proceedings, a substantial increase over the prior decade’s rate, which was below fifty percent.94

Although penalizing the wrongdoers certainly enhances the deterrent effect of the securities laws, it does, by itself, little for the victims who have suffered an economic loss as a result of securities fraud. Prior to the enactment of the Sarbanes-Oxley Act in 2002,95 injured investors could only be compensated with funds obtained by the SEC from securities law violators through a court disgorgement order—civil penalties were not available for compensation purposes and were transferred to the United States Treasury.96 The Sarbanes-Oxley Act authorized the SEC to add civil fines paid in enforcement actions to disgorgement funds.97 These funds, commonly referred to as “fair funds,” are established by the SEC to compensate investors by restoring and distributing ill-gotten

Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978))); id. at 3 n.2 (“Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill-gotten gain.”).

90. See Winship, supra note 86, at 1114–17.
91. See Velikonja, supra note 87, at 339–40; Winship, supra note 86, at 1114–16.
93. See Gretchen Morgenson, At the S.E.C., a Question of Home-Court Edge, N.Y. TIMES (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html (last visited Apr. 17, 2017) (quoting the SEC’s enforcement co-director as saying that the SEC “will be bringing more administrative proceedings”).
96. Generally, civil fines and penalties collected by federal agencies must be remitted to the U.S. Treasury’s general fund. See Velikonja, supra note 89, at 341–42.
gains to victims of a securities law violation. More recently, the Dodd-Frank Act authorized the SEC to distribute civil penalties to victims of securities violations even in cases in which no disgorgement has been ordered by a court. As a result, the SEC may now, at its discretion, transfer funds obtained from (1) disgorgement and (2) civil penalties paid by a defendant following any judicial or administrative enforcement action to a distribution fund earmarked for injured investors.

Though certainly investor-friendly, these recent developments are likely to be of little help to victims of small-scale fraud. Due to limited resources, the SEC cannot investigate all alleged securities violations brought to its attention. In deciding which alleged violations to investigate, the SEC prioritizes based on a number of factors, including the magnitude of the potential violation and its relative harm to investors, the deterrent effects of pursuing such action, the SEC’s visibility in policing key areas, and the resources that would be required. Some commentators have also stressed the role of politics in the SEC’s enforcement decision-making process. Arguably, small and

98. See Cox, Thomas & Kiku, supra note 76, at 754.
101. This concern that the SEC may not have the resources to adequately police the markets is not new. See Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 315 (1985) (noting that “the securities markets have grown dramatically in size and complexity, while [SEC] enforcement resources have declined” and that the SEC “does not have the resources to police the [securities] industry sufficiently”) (internal quotation marks and citations omitted). This has become a bigger issue in an era of government downsizing and increased reliance on the SEC. See Jill E. Fisch, Class Action Reform: Lessons from Securities Litigation, 39 ARIZ. L. REV. 533, 555 (1997) (“Concerns about limiting the size of government and political pressure to reduce expenditures on public enforcement support increased reliance on private enforcement.”).
102. See Human Capital: Major Human Capital Challenges at SEC and Key Trade Agencies: Hearing Before the Subcomm. on Oversight of Gov’t Mgmt., Restructuring & the Dist. of Columbia of the S. Comm. on Governmental Affairs, 107th Cong. 6 (2002) (statement of Richard J. Hillman, Director of Financial Markets and Community Involvement, General Accounting Office, and Loren Yager, Director of International Affairs and Trade, General Accounting Office) (“[The] SEC generally prioritizes the cases in terms of (1) the message delivered to the industry and public about the reach of SEC’s enforcement efforts, (2) the amount of investor harm done, (3) the deterrent value of the action, and (4) SEC’s visibility in certain areas such as insider trading and financial fraud.”); DIV. OF ENF’T, SEC. AND EXCH. COM’N, ENF’T MANUAL 4–5 (2015) (listing factors and considerations to be taken into account when prioritizing investigations); Cox, Thomas & Kiku, supra note 76, at 759 (“[T]he SEC gauges its enforcement priorities by the message the action sends to the industry and public, the relative harm to investors, the deterrent effects of the action, and the visibility the SEC enjoys in combating such abuses.”).
103. See, e.g., Pritchard, supra note 72, at 1018 (“Politicians happily provide the SEC whatever tools it deems necessary to fight insider trading and the SEC cultivates political support through its
local instances of fraud are less likely to be highly ranked under either metric. Not surprisingly, issuers subject to SEC enforcement actions are relatively large and so are the amounts of monetary losses involved.104 Moreover, the fixed costs associated with establishing a fair fund and the administrative costs involved in designing and implementing a distribution plan (e.g., locating the victims to be compensated) make restitution impractical in cases where the amounts of money to be distributed are small.105

B. State Regulation of the Securities Markets

Transactions involving securities are also subject to regulation at the state level.106 Most of the state securities statutes are based on a version of the Uniform Securities Act, a model code which largely tracks the federal regulatory approach described above.107 As under the Securities Act, sales of securities in a state must either be registered or fall within an exemption from registration under the state’s securities law.108 State securities statutes also contain civil liability provisions that mirror their
federal counterpart and grant investors a cause of action against promoters and issuers that sell securities without registration or who, more generally, employ fraudulent schemes in the offer and sale of securities.109

1. The Federal-State Partnership

Although the ineffectiveness of state law in preventing fraud was one of the driving forces behind the enactment of the federal securities laws in the 1930s,110 the latter were intended, at least originally, to complement rather than replace existing state laws.111 This dual regulatory system lasted well into the 1990s,112 when the federal government enacted the National Securities Market Improvement Act (NSMIA).113 NSMIA prohibits states from enforcing their registration requirements for offerings of “covered securities,” a term which includes securities listed on a national exchange or offered in Rule 506 private placements, among others.114 NSMIA sought to reduce the cost of capital for issuers, which previously had to comply not only with all

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109. See Unif. Sec. Act § 509(b) (Nat’l Conference of Comm’rs on Unif. State Laws 2002) (granting rescissory rights to investors who purchase from someone who sold a security “in violation of Section 301 [the Act’s registration provision] or, by means of an untrue statement of a material fact”). Moreover, the general anti-fraud provisions of the Uniform Securities Act which grant standing to public enforcers are substantially based on Rule 10b-5. See Unif. Sec. Act § 101 cmt. (Nat’l Conference of Comm’rs on Unif. State Laws 1956). (This section “is substantially the [SEC’s Rule 10B-5”); Unif. Sec. Act § 501 cmt. 1 (Nat’l Conference of Comm’rs on Unif. State Laws 2002) (“Section 501, which was Section 101 in the 1956 Act, was modeled after Rule 10b-5 . . . .”); Loss & Seligman, supra note 106, at 42.


existing federal requirements, but also with the registration requirements of every state in which they offered and sold securities.\textsuperscript{115}

The merits of NSMIA have been extensively debated, with critics arguing that the broad nature of the statute left a significant portion of the securities markets virtually unregulated both at the federal and state levels.\textsuperscript{116} In an unregulated marketplace for private offerings where the screening and informational functions of registration requirements are absent, retail investors can become easy prey for unscrupulous promoters.\textsuperscript{117} Moreover, to the extent that smaller companies present a disproportionate risk of failure and fraud, expanding exemptions to the registration requirements for these issuers can be particularly problematic.\textsuperscript{118} In fact, anecdotal evidence suggests that after the enactment of NSMIA, fraudulent transactions involving Rule 506 offerings became more prevalent.\textsuperscript{119} To the extent that small, local


\textsuperscript{116} See Jennifer J. Johnson, Fleecing Grandma: A Regulatory Ponzi Scheme, 16 LEWIS & CLARK L. REV. 993, 995 (2012) (“Private offerings largely escape both federal and state regulatory scrutiny.”); Johnson, supra note 115, at 154–55 (“NSMIA’s preemption of state regulation of private placements, therefore, created a regulatory black hole—today, no one regulates these offerings.”).

\textsuperscript{117} See Johnson, supra note 115, at 152 (“Many investors, including vulnerable senior citizens, are victimized each year in dubious securities offerings . . . . Most promoters involved in these questionable investment schemes sell securities pursuant to the so-called private placement exemption of the federal securities law.”); Letter from Joseph P. Borg, President, NASAA, and Dir., Ala. Sec. Comm’n, to Jonathan G. Katz, Secretary, U.S. Sec. and Exch. Comm’n (Mar. 4, 2002), https://www.sec.gov/rules/proposed/s72301/borg1.htm [https://perma.cc/8TYH-JEWD] (“States frequently use violations of their registration provisions as the basis for stopping fraud. A state regulator can issue a cease and desist order or obtain a preliminary injunction by simply proving the existence of a security and the absence of an effective registration statement. Were the states, because of preemption, unable to use this tool, they would have to devote substantial time and effort to prove fraud, which prolongs the public’s exposure to harm and further taxes limited state resources.”).

\textsuperscript{118} See supra note 61.

\textsuperscript{119} See, e.g., Fred Joseph, Colo. Sec. Comm’r, President, North American Securities Administrators Association, News Conference Opening Statement at the National Press Club: An Agenda for Change: How the 111th Congress Can Better Protect Investors (Jan. 29, 2009), http://www.nasaa.org/402/an-agenda-for-change-how-the-111th-congress-can-better-protect-investors/ [https://perma.cc/5W9T-2F35] (stating that Rule 506 offerings have become the favorite Regulation D offering and that many of them are fraudulent); Enhancing Investor Protection and the Regulation of Securities Markets—Part 2: Hearing Before the Comm. on Banking, Hous., and Urban Affairs, 111th Cong. 7 (2009) (statement of Fred J. Joseph, President, N. Am. Sec. Adm’r’s Ass’n) (noting that since NSMIA was enacted, state regulators have witnessed a steady and significant rise in the number of fraudulent Rule 506 offerings); Johnson, supra note 115, at 188 (noting that the Rule 506 offering has become “a favorite vehicle for fraudulent transactions”); Johnson, Fleecing Grandma: A Regulatory Ponzi Scheme, supra note 116, at 999–1000 (describing
securities offerings are more likely to fly under the regulators’ radar and involve less experienced and naive investors, one can safely assume that fraud is likely to be even more pervasive in these offerings.  

Federal preemption has historically been a contentious issue for state regulators because “[m]any of the segments of the market that have been deregulated and that serve small and early-stage issuers involve significant investment risk and fraud.”[121] Recently, this tension came to light during the Regulation A rulemaking process. The final Regulation A rules provide for the preemption of state securities law registration requirements for securities offered or sold in “Tier 2” offerings to “qualified purchasers,” a term broadly defined to include all offerees and purchasers in such offerings.[123] At the time this provision was proposed, the North American Securities Administrators Association (NASAA) strongly objected to this preemption of state law, questioning whether the proposed definition of “qualified purchaser” was consistent with the public interest and the investor protection standards of NSMIA.[124] Individual state regulators also criticized Regulation A+’s preemption of state regulation. William F. Galvin, Secretary of the Commonwealth of Massachusetts, noted:

We are dismayed and shocked to see that the [SEC’s]
Regulation [A+] proposal includes provisions that preempt the ability of the states to require registration of these offerings and to review them. The states have tackled preemption battles on many fronts, but never before have we found ourselves battling our federal counterpart. Shame on the SEC for this anti-investor proposal. This is a step that puts small retail investors unacceptably at risk. We urge the [SEC] to remove these provisions from the rule.

Because many Regulation [A+] offerings will be made by small and early-stage issuers, they will involve significant risks. That makes these offerings a worrisome choice for small retail investors. Moreover, offerings made under the current Regulation A very often have a local character. If that pattern continues, Regulation [A+] offerings will also be sold substantially in the issuers’ home states and in local-area markets. For this reason alone, it is crucial for the states to have a role in overseeing these offerings in order to protect their citizens.125

This preemption battle did not end with the final adoption of the revised Regulation A+ rules. The securities regulators of Montana and Massachusetts filed suit in federal court objecting to and challenging the SEC’s definition of “qualified purchaser” and to the federal preemption of state law in Regulation A+ offerings.126 In their brief, the state administrators also argued that the SEC’s cost-benefit analysis was flawed and that state laws policed by regulators with local knowledge could do more than the SEC to lessen the risks and costs of fraud.127

2.  Enforcement at the State Level

Although NSMIA limits the role of state regulation with respect to the registration of securities, it does not impair a state’s ability to enforce its securities fraud statutes, whether judicially or administratively.128 In

125.  Galvin Letter, supra note 121, at 1–2.
127.  Id. at 27.
128.  Securities Act § 18(c)(1), 15 U.S.C. § 77r(c)(1) (2012); see also Manning Gilbert Warren III, Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud, 60 LAW & CONTEMP. PROBS. 169, 176 (1997); Jones, supra note 111, at 114–15. NSMIA expressly preserved the authority of states to investigate and bring enforcement actions with respect to fraudulent or deceptive practices. 15 U.S.C. § 77r(c)(1) (“Consistent with this section, the securities commission . . . of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions, in connection with securities or securities
recent years, much attention has been devoted to the effectiveness of a system where state and federal actors have co-existing enforcement powers to investigate and prosecute fraud. This debate gained renewed attention following the increased role played by state regulators at the turn of the millennium in pursuing cases of national importance, the type one would expect to be pursued by federal regulators.

On one hand, state enforcement can play a key role in deterring untoward behavior in the national securities markets by bringing enforcement actions in cases that federal regulators should pursue but do not as a result of budgetary constraints or lax enforcement policies. However, one may be concerned about the efficiency of having concurrent investigations and the potential duplication of enforcement costs—existing studies suggest that state actions target firms in the financial sector on an industry-wide basis, significantly overlapping with transactions... with respect to... fraud or deceit.”); Amanda M. Rose, The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis, 158 U. PA. L. REV. 2173, 2175 (2010) (“[I]n addition to facing federal fraud liability at the hands of both the SEC and class action plaintiffs, participants in the U.S. national securities markets also face potential fraud liability at the hands of fifty state governments.”).

129. See, e.g., Jones, supra note 111, at 117–21; Rose, supra note 128, at 2205–10 (arguing for federal government to have sole responsibility for deterring fraud at the national level).


132. See Robert B. Abdieh, Dialectical Regulation, 38 CONN. L. REV. 863, 885–88 (2006) (explaining how overlapping state-federal jurisdiction can help overcome regulatory inertia by creating a “fail-safe” system of redundancy that protects against under-regulation); John C. Coffee, Jr. & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea?, 95 VA. L. REV. 707, 763–66 (2009) (noting that state regulators have incentives to prosecute fraud, are more stringent than the SEC, and often are faster than the SEC in investigating and prosecuting fraud); Jill E. Fisch, Top Cop or Regulatory Flop? The SEC at 75, 95 VA. L. REV. 785, 798 (2009) (“[R]ecent and continuing history of securities-related scandals and SEC failures offers little reason to cut back even minimally on state enforcement efforts.”); Rose, supra note 130, at 1348, 1361.
SEC investigations. Moreover, since state administrators are subject to political pressure, they may cater to their constituents by investigating unpopular companies or using the threat of criminal sanctions to extort civil settlements.

Though the merits of state involvement in investigating and prosecuting securities violations that are “national” in character are debatable, there is greater consensus about the positive aspects of concurrent jurisdiction in enforcement at the local level. Setting aside the resource constraints the SEC faces, a state enforcer is likely to enjoy a comparative advantage relative to its federal counterparts in investigating small, local fraud. State enforcers, for example, are likely to have a better understanding of local conditions and have better access to the information necessary to detect instances of fraud and pursue a case against securities laws violators. Not surprisingly, state

133. See Amanda M. Rose & Larry J. LeBlanc, Policing Public Companies: An Empirical Examination of the Enforcement Landscape and the Role Played by State Securities Regulators, 65 Fla. L. Rev. 395, 396, 399 (2013) (finding that for U.S. companies listed on the New York Stock Exchange, state securities enforcement actions target mostly firms in the financial sector and misconduct implicating an industry-wide scandal, rather than firm-specific misbehavior, and that over ninety percent of these state actions were accompanied by a related federal action or investigation).

134. See, e.g., Christopher R. Lane, Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators, 39 New Eng. L. Rev. 317, 339 (2005) (asserting that “Oklahoma . . . dropped criminal securities fraud charges against WorldCom in return for a promise by the company to create 1600 jobs in the state over the next ten years”); Park, supra note 130, at 158–59; Rose, supra note 130, at 1403–06, 1411 (describing rent-seeking behavior of West Virginia’s securities regulators); Rose, supra note 130, at 1409–11 (finding that while some state actions against nationally traded firms have served to discipline the SEC, others can be characterized as rent-seeking). It is worth noting that the SEC is not necessarily immune from political pressure. See supra note 103 and accompanying text.

135. See Rachel E. Barkow, Insulating Agencies: Avoiding Capture Through Institutional Design, 89 Tex. L. Rev. 15, 58 (2010) (“State AGs can . . . serve a valuable equalizing function by bringing enforcement actions when a federal agency shares the state’s outlook on regulation but lacks the resources to police all infractions.”); Johnson, supra note 115, at 195–96 (noting that the SEC lacks the resources to “police smaller private placements” and arguing that smaller private offerings should be “policed at the local level”).

136. See Rose, supra note 130, at 1372 (“[A] federal enforcer might take the enforcement lead when it enjoys a comparative enforcement advantage relative to a state enforcer (such as a better ability to investigate crimes with a multistate dimension), and a state enforcer might step in when it has an advantage over the federal enforcer (such as when most of the witnesses and evidence are located within the state.”); Rose, supra note 128, at 2206 (“This formulation supports assigning the federal government responsibility for deterring fraud in the national securities markets, while assigning state governments responsibility for deterring fraud targeted at their respective local capital markets.”).

137. See Rose, supra note 130, at 1357–58; Margaret H. Lemos, State Enforcement of Federal Law, 86 N.Y.U. L. Rev. 698, 721 (2011) (observing that “[s]tates may have an investigatory or
regulators have historically focused their enforcement efforts on local, small-time fraud, while the SEC has tackled the bigger cases that touch the national markets.\textsuperscript{138}

II. RECENT INNOVATIONS AT THE STATE LEVEL

As highlighted in the prior section, the expansion of the universe of offerings that are exempt from registration at the federal level has left investors in small and local securities offerings outside the reach of the federal securities laws’ \textit{ex ante} protective mechanisms. And, even though the general anti-fraud provisions of Rule 10b-5 apply to these transactions, in practice, the two principal mechanisms of \textit{ex post} enforcement—private securities litigation and SEC enforcement actions—play a limited role in policing offerings that are small and local in nature. Complicating matters further for small investors, federal law has increasingly preempted the states’ ability to regulate the offering process.

In light of these developments, states have focused their efforts on \textit{ex post} (e.g., enforcement) rather than \textit{ex ante} (e.g., registration) mechanisms to protect investors from securities fraud. To strengthen these \textit{ex post} enforcement mechanisms in the past few decades, several states have expanded the authority of state securities administrators to obtain restitution on behalf of injured investors in civil actions, as well as in administrative proceedings.\textsuperscript{139} More recently, some states have established innovative insurance-type restitution funds that provide partial compensation to victims of securities fraud.\textsuperscript{140} This section identifies and explains these two recent innovations and provides an economic analysis of their policy implications.


\textsuperscript{139} See infra section II.A.1.

\textsuperscript{140} See infra section II.B.1.
A. Expansion of Enforcement Powers of Securities Administrators

The first major innovation or trend at the state level which holds potential for investor protection is state administrative enforcement. Although federal legislation has restricted the states’ ability to regulate the registration and qualification of securities prior to their sale, the authority and power of state securities administrators to police and investigate fraud, including the type of remedies that the administrator may seek to obtain (e.g., restitution or disgorgement) and the forum in which it may do so (e.g., civil court or administrative proceeding), are determined by state law. These represent significant levers for states to deter and punish fraud. As the discussion below illustrates, states have increasingly taken advantage of these levers by expanding the ex post enforcement powers of securities administrators.

1. Historical Development

The Uniform Securities Act of 1956 (USA (1956)) afforded administrators limited statutory power to pursue civil or administrative actions against violators of a state’s securities laws. The original text itself did not even authorize the administrator to issue a cease-and-desist order; rather, the administrator had to file a civil action in state court to obtain any type of injunctive relief against violations of the state securities laws. And such injunctive relief was the only remedy the administrator could obtain in a civil action—state securities administrators lacked the authority to bring a lawsuit in civil court.

141. See supra note 128 and accompanying text. Investigations by securities administrators can lead to three possible outcomes: a criminal action, a civil action, or an administrative proceeding. See ALAN R. BROMBERG, LEWIS D. LOWENFELS & MICHAEL J. SULLIVAN, 6 BROMBERG & LOWENFELS ON SECURITIES FRAUD §§ 12:240-242 (2d ed. 2015).

142. See UNIF. SEC. ACT § 603, cmt. 1 (NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 1985). The original text from 1956 reads as follows:

Whenever it appears to the [Administrator] that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this act or any rule or order hereunder, [he] may in [his] discretion bring an action in the [insert name of appropriate court] to enjoin the acts or practices and to enforce compliance with this act or any rule or order hereunder. Upon a proper showing a permanent or temporary injunction, restraining order, or writ of mandamus shall be granted and a receiver or conservator may be appointed for the defendant or the defendant’s assets. The court may not require the [Administrator] to post a bond.


against those violating the securities laws to obtain civil penalties or any other ancillary relief, including restitution for the victims.\footnote{144}{See Unif. Sec. Act § 603 cmt. 1 ( Nat’l Conference of Comm’rs on Unif. State Laws 2002).}

In the decades following the drafting of USA (1956), several states that adopted the model act expanded the ability of their securities administrators to pursue remedies against securities laws violators by authorizing them to sue in civil court to obtain civil penalties or even restitution on behalf of injured investors.\footnote{145}{See, e.g., Or. Rev. Stat. § 59.255(4)(a) (2015) (court may award “if the court finds that enforcement of the rights of such persons by private civil action, whether by class action or otherwise, would be so burdensome or expensive as to be impractical”); 70 Pa. Stat. and Cons. Stat. Ann. § 1-509(b) (West 2014) (similar); and Wash. Rev. Code § 21.20.390(4) (1974) (similar).}
The text of the subsequent model code, the Uniform Securities Act of 1985 (USA (1985)), reflected this trend. Under USA (1985), a state securities administrator may file a civil action and obtain a court ordered civil penalty, as well as restitution for injured investors or any other remedy the court considers just.\footnote{146}{Unif. Sec. Act § 603(a)(1) ( Nat’l Conference of Comm’rs on Unif. State Laws 1985). A 1987 amendment to the USA (1956) enhanced the powers of securities administrators and expanded the remedies administrators may pursue in civil court against persons who have engaged in violations of the securities laws to include “an order of rescission, restitution or disgorgement.” Unif. Sec. Act § 408(b) ( Nat’l Conference of Comm’rs on Unif. State Laws 1956) (as amended). See Blue Sky L. Rep. ¶ 5548 (C.C.H.), 2009 WL 2996912.}

Currently, there are forty-three states that allow their securities administrators to file civil suits seeking restitution or disgorgement on behalf of injured investors.\footnote{147}{See infra Table 1.}

The ability of state securities administrators to employ administrative actions as a vehicle to police and investigate fraud has also been enhanced in recent years. Under the original text of USA (1956), state securities administrators did not even have the authority to issue a cease-and-desist order as the result of an administrative proceeding.\footnote{148}{See supra note 143 and accompanying text.}

As with the range of remedies available to securities administrators in civil actions, several states experimented with further expanding the authority of their securities administrators by granting them the power to issue cease-and-desist orders in administrative proceedings.\footnote{149}{See, e.g., Calif. Corp. Code § 25532(a) (2017); Fla. Stat. Ann. § 517.221(1) (West 2009). In addition, administrative proceedings can result in denial, suspension, or revocation of a broker-dealer or investment adviser license or of a registration of securities. See Bromberg et al., supra note 141, § 12:240.}
USA (1985) was drafted, a large number of state securities administrators had the authority to issue cease-and-desist orders, either by amendment to their state’s USA (1956) version or through the corresponding state’s administrative procedure law. Reflecting the legislative trend at the time, USA (1985) empowered administrators to issue cease-and-desist orders and granted them the authority to impose civil penalties, subject to statutory ceilings. The most recent model act, the Uniform Securities Act of 2002 (USA (2002)) tracked these developments. Like USA (1985), USA (2002) allows state securities administrators to file a civil action to obtain civil penalties, restitution, or other relief as the court considers appropriate, including rescission and disgorgement. Under USA (2002), the state securities administrator

150. Highlighting the increasing authority of administrators, USA (1985) contains two different sections: one dealing with administrative remedies and one dealing with civil remedies. See UNIF. SEC. ACT §§ 602, 603 (NAT’L CONFERENCE OF COM’RS ON UNIF. STATE LAWS 1985). These two sections replaced a single section in USA (1956). See UNIF. SEC. ACT § 408 (NAT’L CONFERENCE OF COM’RS ON UNIF. STATE LAWS 1956).

151. See UNIF. SEC. ACT § 602, cmt. 1 (NAT’L CONFERENCE OF COM’RS ON UNIF. STATE LAWS 1985). However, most state securities administrators lacked the authority to impose civil penalties. Id.

152. USA (1985) sought to increase the administrative remedies available to administrators to provide them greater flexibility in imposing sanctions. See id.


154. See UNIF. SEC. ACT § 604(d). Under USA (1985), the securities administrator may impose a civil penalty of up to $2,500 for a single violation or $25,000 for multiple violations in one or more related proceedings. Id. § 602(b)(4). The maximum amounts, however, vary by state. See, e.g., N.H. REV. STAT. ANN. § 421-B:23 (2015) ($2,500 per violation and $5,000 aggregate); WIS. STATS. § 551.603(2)(b)(3) (2016) ($5,000 per violation and $250,000 aggregate); MO. REV. STAT. § 409.6-603 (2016) ($10,000 per violation and $1,000,000 aggregate).


156. UNIF. SEC. ACT §§ 603(b)(2)(C), (b)(3). According to the drafters of the model act, section 603 follows USA (1985) in “broadening the civil remedies available when the administrator believes that a violation has occurred” in order to “enable administrators to better tailor appropriate sanctions to particular misconduct.” § 603 cmt. 1.
may also issue cease-and-desist orders or, following an administrative hearing, impose a civil penalty.

Although USA (1985) and USA (2002) expanded the remedies that securities administrators could pursue in administrative proceedings, such remedies were still more limited than those that a court could impose upon request by the administrator. Notably, although the state securities administrator could impose a civil fine as a result of an administrative proceeding, it could not order restitution on behalf of an injured investor (although it could request a court to do so in a civil case). In recent years, a number of states have amended their laws on an individual basis to empower their securities administrators to issue orders requiring defendants to pay restitution. States began to empower their administrators in this manner during the late 1980s and with time, more states amended their laws to grant this authority to their securities administrators. There are now twenty-one states that have authorized their securities administrators to order restitution as a result of an administrative proceeding.

2. Economic Assessment

a. Policy Implications

One of the policy trends identified above is the increase in the amount of monetary damages (whether in the form of civil penalties or a restitution order) that state securities administrators may obtain in civil and administrative actions against violators of the state’s securities laws. This increase should incentivize an administrator to investigate a greater number of securities fraud cases.
From society’s perspective, an increase in the number of actions pursued by state administrators presents benefits as well as costs. An increase in both the size and probability of a potential penalty could, at the margin, deter a greater number of fraudsters from violating the securities laws. Moreover, in those instances where fraud is not deterred, investors may be more likely to receive some compensation for their losses, at least in the states that allow the securities administrator to collect damages on their behalf. But there are also potential costs that should be considered. Not only will the administrator have to spend more resources in commencing and pursuing those additional actions, but those accused of violating the securities laws will also incur costs in establishing their defense. And maintaining the forum in which such actions, whether judicial (civil courts) or administrative (administrative courts), are resolved is costly as well. These social costs would be exacerbated if the administrator has the incentive to bring numerous or unmeritorious actions that are politically motivated, as this could have a chilling effect on capital formation for smaller companies.

The second, and more notable, trend identified above is the increase in the remedies that state securities administrators may pursue in administrative proceedings. Historically, administrators could only obtain certain types of monetary damages, such as disgorgement and fines in civil actions; however, in recent years more states have allowed administrators to recover these type of damages in administrative actions. If pursuing a case administratively is more cost-effective and less time-consuming than pursuing a similar case in state court, the bridging of this gap should lead to a higher number of civil and administrative actions pursued by securities administrators. First, to seek monetary penalties, see Margaret H. Lemos and Max Minzner, For-Profit Public Enforcement, 127 HAW. L. REV. 853, 856–57 (2014) (arguing that public enforcement agencies may seek higher monetary penalties to further deterrence, enhance the administrator’s reputation, or supplement the agency’s budget when allowed to retain the recovered funds).

165. See infra note 267 and accompanying text.

166. For a description of existing investor compensation programs, see infra section II.B.1.b and section II.B.1.c.

167. See infra note 174 and accompanying text.

168. If the state administrator is subject to political pressure it may have the incentive to bring numerous actions to increase its prestige or bring meritless suits in the hopes that the defendant chooses to settle to avoid a costly proceeding. See supra note 134 and accompanying text.

169. See supra notes 148–58 and accompanying text.

170. See supra notes 94–95 and accompanying text. This effect will be even stronger if securities administrators believe that they have a higher probability of success in administrative actions compared to civil actions. See supra notes 82–84 and accompanying text.
instead of bringing a particular case in state court, the administrator may choose instead to pursue that case in an administrative proceeding. Second, there may be cases that the administrator does not find economically justifiable to bring in state court, but that may now be economically feasible to pursue in an administrative proceeding.  

By increasing the likelihood of a wrongdoer receiving a penalty, such additional actions could enhance the deterrent effect of the securities laws. Moreover, in the cases in which restitution is ordered, victims are also more likely to receive compensation. Thus, at a first glance, enhancing the authority of state administrators in this manner appears to promote the goals of deterrence and compensation. There are, however, potential monetary and non-monetary costs associated with such increased use of administrative proceedings, which are discussed next.

b. Lessons from the SEC’s Recent Experience

The growing ability of state administrators to seek ancillary remedies in civil court, and more recently, to order restitution in administrative proceedings, parallels the rising role of SEC administrative actions in securities law enforcement at the federal level. These recent developments at the federal level can provide valuable insights as to the likely results of such expansion of administrative power at the state level. The SEC’s response to the expansion of its administrative powers does suggest that state administrators are likely to bring an increasing number of administrative actions. Moreover, the SEC’s experience also highlights two potential concerns associated with such increased frequency in administrative actions: (1) monetary costs associated with maintaining administrative courts, and (2) the perception of fairness in administrative proceedings.

Although the costs for the SEC to bring an action in an administrative court may be lower, maintaining that specialized administrative court in the first place is expensive; and to preserve the quality and expediency of the system, the number of judges needs to increase in tandem with a


173. See supra notes 93–94 and accompanying text.
Growing caseload.\textsuperscript{174} Given the volume of the SEC’s workload, those costs may be reasonable. This calculus, however, may be different for individual states with a lighter workload that may not justify the fixed costs associated with maintaining a specialized court.\textsuperscript{175} Thus, even if state securities administrators would enjoy the same benefits associated with administrative proceedings, one may be concerned whether they would be able to find the personnel to staff such a specialized court and whether the costs of operating such courts would be prohibitive (or at least offset any efficiency gains). Of course, states do not need to have specialized securities courts and could employ the more general administrative courts established under the states’ administrative procedure acts. But then, some of the benefits associated with administrative proceedings would not be fully enjoyed.

Another open question is the extent to which administrative proceedings can be fair to defendants, an issue that has led a number of defendants to challenge in federal court the decisions by the SEC to pursue actions against them before an administrative judge.\textsuperscript{176} Defendants have argued that administrative actions unfairly deny them important protections afforded by the federal courts and have questioned the relative fairness of the system, noting that SEC judges appear biased toward the agency.\textsuperscript{177} Not only are judges appointed by the SEC, but they have their offices in the SEC headquarters, which exposes them to

\textsuperscript{174} During the year 2014, the SEC added two new administrative law judges, bringing the number of judges at the time to five. Moreover, for the fiscal year 2015 the budget for the administrative law judge’s office rose forty-four percent to $2.5 million. See Eaglesham, supra note 94.

\textsuperscript{175} Even though bringing an administrative action appears to be more economical than a civil suit from the administrator’s perspective, those savings may be offset by the higher costs associated with maintaining the administrative court relative to just increasing the capacity of the existing civil court system.


\textsuperscript{177} See Eaglesham, The SEC Fights Challenges to Its In-House Courts, supra note 83. Thus far, these challenges have met with little success at the appellate level. See Aruna Viswanatha, Appeals Court Upholds SEC’s In-House Court as Constitutional, WALL ST. J. (Aug. 9, 2016), http://www.wsj.com/articles/appeals-court-upholds-secs-in-house-court-as-constitutional-1470766508 [https://perma.cc/P34X-YFFV].
pressure and raises questions regarding the judges’ objectivity. Moreover, appeals of rulings rendered by the SEC’s administrative law judges are heard by the five SEC Commissioners and reversals are not common. It is hard to assess how big a problem this would be in the context of state administrative actions. State securities administrators generally do not wield the power that the SEC does and decisions by administrative judges would be reviewed by the state appellate courts, not the state securities administrator itself.

c. Potential Solutions

The states’ challenge in funding these specialized administrative courts and promoting their political independence could be addressed by a set of specialized administrative courts supported by multiple states. Such specialized courts would apply the laws of the relevant jurisdiction and its decisions would be subject to appeal to the corresponding state’s appellate court. There are several tangible benefits associated with such a system. First, this system would allow the states to share the fixed costs of maintaining a specialized administrative court dealing with matters involving securities laws. Second, the judges in these administrative courts would be exposed to a more diverse set of cases, thus gaining more specialized knowledge and expertise. Third, these

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178. Recent empirical analyses suggest that this may not be a trivial concern. According to an analysis by the Wall Street Journal, the SEC won 90% of the time before its own judges in contested cases between October 2010 and March 2015, substantially higher than the 69% success rate enjoyed by the SEC in federal court over the same period. See Eaglesham, SEC Wins With In-House Judges, supra note 80. This success rate probably underestimates the administrative court effectiveness, as it is also likely to provide incentives for defendants to settle. See Eaglesham, Fairness of SEC Judges in Spotlight, supra note 80 (reporting an instance where a SEC judge told defendants that he had never ruled against the SEC’s enforcement division). It is worth noting that these are raw figures and that the Wall Street Journal’s analysis does not control for differences in the characteristics of cases resolved in each type of forum. A more recent and rigorous study finds no evidence that the SEC is more likely to prevail in administrative actions. See Velikonja, supra note 85, at 348–49.

179. According to the Wall Street Journal Study, commissioner outcomes favored the SEC in fifty-three of fifty-six cases—or 95%—from January 2010 through March 2015. See Eaglesham, supra note 94.

180. The position of securities administrators within the government structure varies from state to state. In some states the securities administrator is supervised by the attorney general’s office, in others, by the secretary of state and, in others, by the department of corporations, banking, or finance. For a list of state securities administrators, see Contact Your Regulator, NASAA, http://www.nasaa.org/about-us/contact-us/contact-your-regulator [https://perma.cc/TG48-F6MW].

181. Some large states, such as California and New York, for example, would not need to enter this type of arrangement, as their caseload possibly justifies maintaining a sophisticated specialized court. Smaller states, however, could potentially benefit from such an arrangement.
judges may be more easily insulated from political pressure (though this will certainly depend on how they are appointed), assuaging defendants’ concerns about fairness. Finally, such a system may help in maintaining the uniformity across states that has been achieved by the adoption of the uniform securities acts.

States could choose to work together based on geographical proximity and similarity in their securities laws. Although such enterprise may require amendments to the securities laws and administrative procedural acts of participating states, there is no reason to believe that this would be unfeasible. The adoption of the different versions of the uniform securities acts has led to uniformity in state law, which facilitates this regulatory harmonization process.182 And state administrators have effectively cooperated on a number of fronts. For example, the states, with the support of the North American Securities Administrators Association, have created a voluntary coordinated review program that facilitates and expedites the process for issuers who need to make filings with multiple state securities regulators as part of a securities offering.183 And, more generally, states have a long history of entering into interstate compacts and interstate administrative agreements, as well as delegating rule-making authority to interstate administrative agencies to address and efficiently solve common problems.184

B. State Restitution Funds as a Vehicle for Investor Compensation

As noted, victims of securities fraud may be unable to recover their losses for a number of reasons.185 Going to court may not be economically viable given the relatively high costs associated with

182. See supra section II.A.1.

183. COORDINATED REVIEW, http://www.coordinatedreview.org [https://perma.cc/592S-MNXZ], provides an overview of this program. NASAA has been promoting this program to facilitate the use of Tier 1 Regulation A+ offerings, which, unlike Tier 2 offerings, require registration at the state level. See supra notes 54–55, 123 and accompanying text.


185. See supra notes 68–69 and accompanying text.
bringing a lawsuit, the probability of losing, and the relatively small amounts of money involved. And, even if an investor prevails, the defendant may be judgment proof (i.e., does not have sufficient personal assets to satisfy a judgment) or the costs of enforcing and satisfying the judgment may be just too high. Administrative enforcement of anti-fraud laws is one way of dealing with the first problem—the state can bring an action and absorb the costs even if the defendant is judgment proof to the extent that pursuing such action deters future violations of the law. However, it does not, by itself, address the investor’s lack of compensation problem.

To address this second problem, and mitigate the social costs of securities fraud, certain states have established insurance-type programs to assist victims of securities fraud and allow them to obtain compensation and recover part of their losses. This development, much like the increased use of administrative actions discussed earlier, mirrors the increased use by the SEC of fair funds to compensate injured investors. In 2010, Indiana became the first state to adopt legislation creating a special fund to provide restitution to victims of securities fraud. Montana followed suit in 2011, establishing a similar program. The Montana and Indiana programs, which are described later in this section, appear to be an extension of an investor compensation program established in Florida almost forty years ago, which is discussed next.

186. See Polinsky, supra note 68, at 107 (arguing that enforcement by a public agent may occur even when potential penalties are lower than the enforcement costs due to the value of deterring future violations); Steven Shavell, The Social Versus the Private Incentive to Bring Suit in a Costly Legal System, 21 J. LEGAL. STUD. 333, 333–34 (1982) (noting that bringing lawsuits may produce externalities, such as deterrence, which are not taken into account by private plaintiffs); Luis A. Aguilar, Speech at the 20th Annual Sec. Litig. and Reg. Enf’t Seminar: A Stronger Enforcement Program to Enhance Investor Protection, https://www.sec.gov/news/speech/2013-spch102513iaa [https://perma.cc/NR7R-VYLZ] (noting the value of deterrence in the enforcement of securities laws). Moreover, the state may derive value from non-monetary remedies available to it, such as injunctive relief, as it may prevent future investors from being harmed by the same perpetrator. See supra note 149. This is not the case for individual plaintiffs (or their attorneys) for whom the benefits associated with a lawsuit are likely to be mainly monetary.

187. See supra notes 97–100 and accompanying text.


189. See infra notes 213–21 and accompanying text.

190. Kansas also considered enacting a similar program in 2012. See infra notes 223–24 and accompanying text.
1. Historical Development

a. Florida’s Securities Guaranty Fund

The Securities Guaranty Fund (SGF) was created as part of the enactment of the Florida Securities Act of 1978 to assist victims of securities laws violations.\(^1\) The SGF is funded by a portion of the assessment fees paid by dealers and investment advisors as part of their initial registration or renewal applications.\(^2\) Investors that have obtained a court judgment against a licensed dealer or investment advisor as a result of a transaction involving the sale of unregistered securities or securities fraud are eligible to seek recovery from the SGF.\(^3\) Prior to pursuing a claim with the SGF, the investor must take reasonable steps to verify that the judgment debtor possesses no assets that could be sold or applied in satisfaction of the judgment.\(^4\) An investor may apply to and receive from the SGF an amount equal to the unsatisfied portion of the investor’s judgment or $10,000, whichever is less.\(^5\) However, the payments of claims against any one dealer or investment adviser are limited in the aggregate to $100,000—if total claims exceed this limit, the SGF must prorate the payments to the harmed investors.\(^6\) To allow the fund to ascertain whether the $100,000 cap will be binding for a particular set of claims, investors must wait two years from the date any claimant is found to be eligible for recovery before receiving payment based on any claim against any one dealer or investment adviser.\(^7\)

As discussed earlier, the effectiveness of private enforcement of anti-fraud laws is limited by the fact that certain defendants may be judgment


\(^2\) § 517.131(1)(a).

\(^3\) §§ 517.131(2), 517.07, 517.301.

\(^4\) § 517.131(3).

\(^5\) § 517.141(1).

\(^6\) § 517.141(2).

\(^7\) § 517.141(3).
proof, which may delay and increase the costs for an injured investor to
collect an award. 198 Thus, certain investors who prevail at trial may end
up receiving little or no compensation for their losses, which decreases
investors’ incentive to bring a lawsuit in the first place. This, in turn,
reduces the deterrent effect of the securities laws on promoters (and the
broker dealers who assist them) by reducing the costs associated with
fraudulent activities. By guaranteeing investors that prevail in court a
minimum recovery, a program such as the SGF could provide investors
not only with partial compensation for the losses, but also with
additional incentives to incur the expenses associated with bringing a
lawsuit.

From an investor’s perspective, the SGF has certain noteworthy
drawbacks. Investors may only recover in situations where the fraud is
committed by a dealer or investment advisor and, even then, recovery is
capped at $10,000 (or even less if the total claims against the defendant
are more than $100,000). 199 Before submitting a claim against the fund,
the investor must first obtain a court judgment and try to satisfy that
judgment against the defendant’s assets. 200 This means that the investor
will have to spend time and money on court-related expenses (e.g.,
attorney fees), which can be a risky proposition, particularly in light of
the limited recovery available under the SGF. And, even then, investors
must wait two years before being able to receive compensation. 201 These
factors decrease the net compensation that investors may expect to
receive from the fund, reducing their incentive to bring a lawsuit against
persons violating securities laws.

b. Indiana’s Securities Restitution Fund

In recent years, states have begun to experiment with investor
compensation programs that are more comprehensive than Florida’s
SGF. In 2010, Indiana enacted legislation establishing a special fund
aimed at providing restitution for victims of securities fraud. 202 To be
eligible, an investor must have suffered monetary loss as a result of a
“[s]ecurities violation” (which is broadly defined) 203 and have a court or

198. See supra notes 68–69 and accompanying text.
199. §§ 517.131(2), 517.141(1).
200. § 517.131(2).
201. § 517.141(3).
203. IND. CODE § 23-20-1-6. The term “[s]ecurities violation” is broadly defined to include a
violation of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment
administrative agency order awarding restitution to the investor.\textsuperscript{204} If the securities violation occurred outside Indiana, residents of Indiana might still recover from the fund if the jurisdiction in which the securities violation occurred does not offer them comparable assistance.\textsuperscript{205} Notably, nonresidents who are victims of a securities violation committed in Indiana are also eligible if the jurisdiction in which the victim resides offers Indiana residents comparable assistance.\textsuperscript{206} If the party that was ordered to pay restitution has not paid the amount in full, the investor may apply to receive a payment from the fund.\textsuperscript{207} Eligible victims may receive an award equal to the lesser of twenty-five percent of the amount of the out-of-pocket loss or $15,000.\textsuperscript{208}

The fund was established with an initial $2 million endowment from fines paid by defendants to the Indiana Securities Division and five percent of the amounts collected for the securities division’s enforcement account, which includes costs of investigation and civil penalties recovered in cases of securities violations.\textsuperscript{209} Thus, it does not directly depend on any general tax revenues, though arguably it indirectly consumes resources that would otherwise have gone to the state general funds.\textsuperscript{210} The first payment from the Securities Restitution Fund, in the amount of $15,000, was awarded to an investor who lost

\textsuperscript{204} The order awarding restitution must have been issued following the adjudication of the underlying securities violation in a state or federal court, or a regulatory agency administrative proceeding. § 23-20-1-12(a).

\textsuperscript{205} §§ 23-20-1-9, 23-20-1-16(b)(1), 23-20-1-17. The order awarding restitution must have been issued following the adjudication of the underlying securities violation in a state or federal court, or a regulatory agency administrative proceeding. § 23-20-1-16(a).

\textsuperscript{206} § 23-20-1-11(1).

\textsuperscript{207} §§ 23-20-1-9, 23-20-1-16(b)(2). The victim must file an application within 180 days from the date of the order that entitles the victim to restitution. § 23-20-1-12(b).

\textsuperscript{208} § 23-20-1-23. The term “out-of-pocket loss” is defined as an amount equal to the restitution ordered by the underlying court or administrative final order. § 23-20-1-4.

\textsuperscript{209} §§ 23-20-1-25(b)(2), 23-19-6-1(h). If the amount of money in the fund drops below $250,000, the securities administrator must suspend payments for that month and the following two months. § 23-20-1-28(a). If after this suspension period the fund would be exhausted by payment in full of the suspended claims, then the amount paid to each claimant must be prorated. § 23-20-1-28(b).

\textsuperscript{210} For a discussion of the opportunity costs of these investor restitution programs see infra section II.B.3.b(2). Moreover, if the fund did not have enough money to satisfy all claims for an extended period of time, it is possible the general assembly could appropriate funds derived from tax revenues for the restitution program. § 23-20-1-25(b)(2).
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$400,000.\textsuperscript{211} As of December 2016, the Indiana Securities Restitution Fund had made nearly $550,000 in restitution payments.\textsuperscript{212}

c. Montana’s Securities Assistance Restitution Fund

In 2011, following Indiana’s footsteps, Montana established the Securities Restitution Assistance Fund (SRAF)\textsuperscript{213} to provide partial compensation to victims awarded restitution in a final order issued by the commissioner or in a final order in a legal action initiated by the commissioner, but who have not yet received the full amount of restitution.\textsuperscript{214} Montana’s program is narrower than Indiana’s in the sense that it only covers securities transactions in Montana that violate Montana law\textsuperscript{215} and only Montana residents are eligible for assistance, but it does provide a more generous compensation cap.\textsuperscript{216} An eligible victim may receive from the fund an award equal to the lesser of $25,000 or twenty-five percent of the amount of unpaid restitution.\textsuperscript{217} If the victim qualifies as a “[v]ulnerable person” the maximum award is the lesser of $50,000 or fifty percent of the amount of unpaid restitution.\textsuperscript{218}


\textsuperscript{213} 2011 Mont. Laws 207 (codified in MONT. CODE ANN. §§ 30-10-1001–30-10-1008 (2015)).

\textsuperscript{214} MONT. CODE ANN. §§ 30-10-1002; 30-10-1003(1)–(6).

\textsuperscript{215} The term “[s]ecurities violation” includes violation of Montana’s securities act and any related administrative rules, § 30-10-1003(5). Indiana residents who were victims of securities fraud in other jurisdictions are eligible for restitution under the Indiana program. IND. CODE § 23-20-1-11(1)(B) (2015).

\textsuperscript{216} MONT. CODE ANN. § 30-10-1005. Under Indiana’s program certain non-residents may be eligible for restitution assistance. IND. CODE § 23-20-1-11(2).

\textsuperscript{217} MONT. CODE ANN. § 30-10-1006(3). If the SRAF’s balance falls under $1 million, the commissioner must use an established loss ratio to determine how much money a person may receive. MONT. COMM’R. OF SEC. & INS. RULES 6.10.702-703. However, a recent amendment to the program has made this scenario less likely. See infra notes 219–20 and accompanying text.

\textsuperscript{218} This was part of an amendment to the program enacted in 2015. 2015 Mont. Laws 86 (codified in MONT. CODE ANN. § 30-10-1006(4)). A “[v]ulnerable person” is defined as a person who: (a) is at least sixty years old; (b) suffers from mental impairment because of a condition typically related to advanced age (such as dementia or memory loss); or (c) has a developmental disability. § 30-10-1003(7).
Originally, the fund was to be financed by contributions from individuals who had violated certain provisions of the Montana Securities Act. Subsequent legislation made public funds available to the SRAF by temporarily authorizing the deposit of a percentage of securities registration, filing or renewal fees into the SRAF. The first payment from Montana’s SRAF, in the amount of $13,750, was made in July 2012 to Reece Cobeen, who had invested $55,000 in notes offered and sold purportedly to help rebuild homes in Louisiana after Hurricane Katrina, and which promised a twenty-four percent annual return. As of June 2016, the Montana Securities Restitution Fund had distributed over $1 million to more than seventy-five Montana victims of securities fraud.

d. Other State Efforts

Although no other state has yet followed Montana and Indiana’s footsteps, some states have considered establishing similar programs. In 2012, the Office of the Kansas Securities Commissioner introduced legislation that would have created a securities restitution fund administered by the administrator to provide restitution to Kansas residents who have been awarded damages in connection with violations of Kansas’s securities laws and regulations. The proposed legislation was vague in the details, granting the commissioner broad authority to adopt rules to specify definitions, forms, procedures, and limitations for payment of restitution awards from the fund. Kansas’s assembly never enacted this proposed legislation. In 2013, New Hampshire considered establishing a restitution fund to compensate investors who lost money in a major fraudulent scheme but never adopted the measure.
2. Policy Framework for Assessing Restitution Funds

From an injured investor’s perspective, the restitution funds established by Montana and Indiana address many of the limitations of Florida’s SGF. First, investors may bring claims relating to securities violations committed by any person, not just dealers and advisors. Second, investors do not need to first file a civil lawsuit and obtain a judgment to be eligible—an administrative order or a court order in an action brought by the securities administrator will suffice. This is quite important as most, if not all, investors in small transactions may not find it economically viable to bring a lawsuit in the first place. Finally, the caps on the amount recoverable by investors under both the Indiana and Montana programs are higher than that of Florida’s SGF.

Overall, this new generation of investor compensation programs appears to provide greater protection for investors by increasing their chances of receiving at least partial compensation. Of course, a program that merely maximizes the expected compensation received by injured investors is not necessarily desirable or optimal from society’s perspective. Two comparable initiatives—securities fraud insurance and crime victim compensation funds—provide an analytical framework with which to assess the policy justifications and social welfare implications of these securities fraud restitution programs.

a. Restitution Funds as Insurance Against Fraud

The securities restitution funds closely resemble investor misinformation (or securities fraud) insurance programs that have been proposed by scholars to supplement or replace securities class actions.
Although the specifics of these proposals differ, they all are grounded on the shortcomings of private securities litigation and public enforcement in achieving the goals of deterring fraud and compensating its victims. The main criticisms of these insurance schemes relate to their effect on investor behavior: namely, that investors can protect themselves more efficiently against fraud (e.g., by diversifying), and that insuring investors against fraud can lead to suboptimal investment decisions (e.g., moral hazard). A second set of critiques is grounded on fiscal concerns.

Critics of these fraud insurance schemes note that investors can easily eliminate the risk of fraud by just owning stock in several companies (i.e., by diversifying their portfolios). A brief example illustrates this point. Assume that an ongoing fraud is inflating the market price of the stock of a company by $5 (i.e., so that the price of the stock would drop by $5 if the truth was revealed). Investor A, a holder of the stock, sells it to investor B at market price. In this particular transaction, investor A is a winner and investor B is a loser (i.e., A sold B inflated stock). However, in other transactions investor B may end up on the winning side of the deal, selling a security at an artificially high price or buying at an artificially low price. If the probability of being in the losing or winning side is random, then an investor is as likely to gain or lose by


232. For example, Evans’s proposed Investor Compensation Fund (ICF) would be administered by the SEC and funded by a mandatory fee collected by exchanges in transactions involving publicly-traded stock. See Evans, supra note 74, at 241–42. If a threshold number of shareholders complain or the SEC enforcement division brings charges against an issuer, the ICF would then conduct an investigation and make damage awards determinations employing administrative style proceedings. See id. at 246–47.

233. See supra section I.A.1; Tom Baker, Insurance Against Misinformation in the Securities Market, in TASK FORCE TO MODERNIZE SECURITIES LEGISLATION IN CANADA 373 (June 5, 2006) (arguing that the market addresses the risk of investment losses due to misinformation by securities litigation, public enforcement, and diversification by investors); John C. Coffee, supra note 72, at 1538 (noting that securities class actions have two main policy goals: compensation and deterrence).

234. See infra notes 237–48 and accompanying text.

235. See infra notes 249–53 and accompanying text.

236. See infra notes 254–56 and accompanying text.

237. See, e.g., Sean J. Griffith, Daedalean Tinkering, 104 Mich. L. Rev. 1247, 1257 (2006) (arguing that losses guaranteed under Skeel’s investor protection program are capable of being spread without cost by holding a diversified portfolio).
fraud and, on average, if the investor holds enough stock in different companies, the gains and losses should balance out.

This idea can be more rigorously articulated by reference to modern portfolio and asset pricing theory, which divides risk into two types—idiosyncratic (or firm specific) risk and systemic (or market) risk. Because an investor can nearly eliminate the idiosyncratic risk associated with owning a security through diversification, the market only compensates investors for the market (or undiversifiable) risk they bear. If the risk of fraud is just like any other ordinary idiosyncratic risk that can be easily eliminated via diversification, then investors will not be compensated for bearing that risk and thus rational investors will just diversify their portfolios to deal with this problem.

Though persuasive in theory, the diversification argument has little purchase in the context of small-scale securities fraud. An underlying assumption of this critique is that fraud occurs after the securities have been sold by the issuer to public investors and that insiders are not involved in the trade (i.e., purely secondary market fraud).

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238. See Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 STAN. L. REV. 1487, 1502 (1996); Richard A. Booth, Class Conflict in Securities Fraud Litigation, 14 U. PA. J. BUS. L. 701, 706 (2012) (“[A] diversified investor is effectively insured against securities fraud.”); Richard A. Booth, The End of the Securities Fraud Class Action as We Know It, 4 BERKELEY BUS. L. J. 1, 7 (2007) (“A diversified investor is equally likely to be on the winning side of a given trade as on the losing side. Thus, a diversified investor is already effectively protected against securities fraud in most cases.”).

239. See Evans, supra note 74, at 227–28.

240. See Booth, Class Conflict in Securities Fraud Litigation, supra note 238, at 712 (“An undiversified investor assumes unnecessary risk for the same expected return that diversified investors enjoy.”). Existing studies indicate a portfolio containing as few as twenty stocks can eliminate more than ninety-nine percent of firm-specific risk. See Franco Modigliani & Gerald A. Pogue, An Introduction to Risk and Return: Concepts and Evidence, 30 FINANCE J. 68, 74–75 (1974) (finding that a portfolio of twenty stocks can essentially eliminate company specific risk).

241. See Booth, The End of the Securities Class Action as We Know It, supra note 238, at 13 (arguing that the risk of simple securities fraud is like any other ordinary business risk).

242. See id. at 7 (“Through diversification, an investor can avoid significant company-specific risk without any reduction in return and can do so at no cost. Because it is irrational to assume more risk than necessary, it follows that rational investors diversify.”); Pritchard, supra note 72, at 946 (“[C]ompensation [in the form of securities class actions] as a form of insurance makes little sense if the victim of fraud can avoid the risk at a lower cost.”).

243. Some scholars are skeptical of this argument even in cases involving secondary market fraud. See, e.g., Booth, The End of the Securities Class Action as We Know It, supra note 238, at 5 (arguing that if the price declines not just to where it would be in absence of fraud but goes lower due to uncertainty, then losses to investors exceed their gains and investors on average lose on account of fraud); Evans, supra note 74, at 229.

244. See Booth, The End of the Securities Class Action as We Know It, supra note 238, at 9 (“Diversified investors suffer no harm from securities fraud except in those cases in which insider trading subtracts wealth from the market.”); John C. Coffee, supra note 72, at 1537 (“In the typical
assumption is what allows investors to sometimes end up on the winning side of the transaction. However, in the context of the small-scale fraud that is the subject of this Article, the fraud often occurs when the issuer or the promoter sells the security to investors. One could argue that the risk of fraud associated with acquiring illiquid securities from a promoter in a small offering can still be partially diversified by holding a portfolio that is heavily weighted toward securities listed on a national exchange and purchased in the secondary market. But here, we encounter another problematic assumption of the diversification argument: investors will diversify because it is rational to do so. Existing empirical evidence strongly suggests that investors do not diversify, a phenomenon that can be attributed to a number of factors. To the extent that financial sophistication and diversification are correlated, it would not be surprising to find that victims of small-scale fraud are not diversified.

A second economic critique of fraud insurance schemes centers around the problem of moral hazard—once individuals are insured against a risk, they have less incentive to avoid or reduce the loss associated with that risk. In other words, having insurance against fraud may reduce the incentive of investors to avoid investing in securities that pose higher risk and, as a result, investors may be less careful and take socially undesirable risks that they would otherwise have not taken in the absence of insurance. The problem of moral hazard is not trivial or theoretical—according to some scholars, moral

245. See Pritchard, supra note 72, at 945–46 (“If fraud on the market can, for the most part, be diversified away, investors’ losses from trades affected by that fraud are not really a social cost.”).

246. See Booth, The End of the Securities Class Action as We Know It, supra note 238, at 11–12 (arguing that if investors can diversify away risk of fraud, then it is rational for them to do so; and the law should only protect reasonable investors); Evans, supra note 74, at 230.

247. See Evans, supra note 74, at 234 (citing evidence from the survey of consumer finances published by the Federal Reserve which finds that almost sixty percent of individual investors hold stock in three or fewer companies and thirty-five percent hold just one).

248. See id. at 235 n.50 (noting the reasons explaining this lack of diversification, which include an illusory sense of control stemming from direct involvement in the investment process and gambling tendencies, among others).


250. See Baker, supra note 233, at 381; Griffith, supra note 237, at 1256 (arguing that fraud insurance schemes will lead investors to take on more risk).
hazard problems caused by deposit contributed to the 1980s savings and loans crisis.\footnote{251}{See Griffith, supra note 237, at 1256 (drawing a comparison between the moral hazard that would be created by securities fraud insurance and the moral hazard problems created by deposit insurance regimes that led to the savings and loan crisis of the mid 1980s); Geoffrey P. Miller, \textit{Banking Regulation: The Future of the Dual Banking System}, 53 \textit{Brook. L. Rev.} 1, 19 (1987) (explaining that deposit insurance creates moral hazard by giving banks the incentive to take excessive risks because they capture the benefits while the costs are borne by the insurance fund); Kenneth E. Scott, \textit{Never Again: The S&L Bailout Bill}, 45 \textit{Bus. Law.} 1883, 1898 (1990) (“The magnitude of [the FDIC and FSLIC losses] . . . was occasioned by a literal explosion of . . . moral hazard.”).}

Insurance markets have devised a number of mechanisms to minimize the impact of moral hazard by providing adequate incentives for the insured to take precautions to prevent harm from occurring. Insurance contracts achieve this by providing only partial coverage for an insured’s losses (i.e., requiring the insured to share part of the loss) via deductibles (i.e., a baseline amount of the loss that must be absorbed by the individual), copayments (i.e., a percentage of the loss above the deductible that is not covered), and coverage limits (i.e., capping the amount of losses that are recoverable).\footnote{252}{See generally Ronen Avraham, \textit{The Economics of Insurance Law – A Primer}, 19 \textit{Conn. Ins. L. J.} 30 (2012), 70–71 (describing various contractual solutions to the moral hazard problem in the insurance context). In addition, insurance companies obtain subrogation rights, which allow the insurer to seek redress from responsible parties. \textit{Id.} at 81.} As discussed later in this Article, the securities restitution funds have features that mimic these mechanisms, providing some reassurance that moral hazard will not lead to an unraveling of these programs.\footnote{253}{See \textit{infra} notes 271–75 and accompanying text.}

The final set of concerns highlighted by critics of the securities fraud insurance schemes are fiscal in nature—the associated costs and the manner the programs are funded. Effectively administering these insurance schemes is likely to consume significant monetary and human resources, and if the costs are high enough, they may effectively offset any relative benefits associated with the insurance programs.\footnote{254}{See \textit{Griffith}, supra note 237, at 1255–56 (criticizing an existing investor compensation scheme proposal “based on administrability and cost”).} In addition, there are opportunity costs and distributional concerns as well.\footnote{255}{See \textit{id.} at 1256.} The relevance of these fiscal and distributional issues in the context of the securities restitution funds is addressed later in this Article.\footnote{256}{See \textit{infra} section II.B.3.b.}
b. Restitution Funds as a Crime Victim Compensation Fund

The securities restitution funds also share some features with crime victim compensation programs. Generally, to be eligible under these compensation programs, an individual must have been a victim of a violent crime and suffered bodily injury or death. In addition, the victim must facilitate law enforcement’s prosecution efforts by reporting the crime promptly and cooperating with police and prosecutors. Qualifying victims may be compensated for certain eligible expenses related to the criminal injury. However, the total available award is often capped (with the maximum varying by state), and in some states eligibility is conditioned on financial need. Victim compensation programs are predominantly financed by criminal fines and penalties,


259. See, e.g., 42 U.S.C. § 10602(b)(2) (requiring programs to promote cooperation with law enforcement).


261. All states cap monetary recovery at amounts ranging from $5,000 to $180,000, with an average cap of approximately $35,000; in 2001, the median award nationally was $2,400. See Julie Goldscheid, Crime Victim Compensation in a Post-9/11 World, 79 TUL. L. REV. 167, 190 (2004). For example, in Indiana, the maximum award under the victim compensation program is $15,000, which coincides with the maximum award under the investor restitution fund. IND. CODE § 5-2-6.1-35(a)(1).

262. See, e.g., FLA. STAT. § 960.13(8); KAN. STAT. ANN. § 74-7305(d) (2016); KY. REV. STAT. ANN. § 346.140(3) (2016); MICH. COMP. LAWS § 18.361(7) (2016); and N.Y. EXEC. LAW § 631(6)(a) (2016).
federal Victims of Crime Act of 1984 (VOCA) grants and, in a few states, general revenue funds.\(^{263}\)

Several rationales have been offered in support of victim compensation programs.\(^{264}\) The first set of justifications relates to the state’s obligation to maintain safety and security. Because the maintenance of safety and security is a public good provided by the state, when someone falls prey to a violent crime, the state has failed and thus must compensate the victim.\(^{265}\) Crime victim compensation programs serve as a way of distributing the costs of crime across society—i.e., as a system of public insurance that covers a risk (crime) to which all citizens in a society are exposed and thus helps spread the losses that result from that risk by compensating victims and enhancing social welfare.\(^{266}\) This first set of justifications for victim compensation programs is not persuasive in the context of securities fraud.

A second set of justifications suggests that victim compensation programs may also have a deterrent effect by increasing the size of the penalty paid by criminals and their probability of being detected, potentially playing a role in reducing crime.\(^{267}\)

\(^{263}\) See HERMAN AND WAUL, supra note 257, at 23. State compensation programs that meet certain criteria are eligible to receive federal VOCA grants, which are also funded by federal criminal fines and penalties. 42 U.S.C. §§ 10602(a)-(b)(6), 10601(b).

\(^{264}\) See Goldscheid, supra note 261, at 212 (organizing these rationales into four groups: legal obligation, social welfare, shared risks, and support to the criminal justice system).

\(^{265}\) See, e.g., JEREMY BENTHAM, POLITICAL REMEDIES FOR THE EVIL OF OFFENSES (1838), reprinted in CONSIDERING THE VICTIM 29–42 (Joe Hudson & Burt Galaway eds., 1975) (arguing that the community ought to be taxed to repair the damage caused because it bears responsibility for violent offenses); Robert D. Childres, Compensation for Criminally Inflicted Personal Injury, 39 N.Y.U. L. Rev. 444, 455–56 (1964) (arguing that aside from the criminal, the state is the party “next most responsible” for the crime); Margery Fry, Justice for Victims, 8 J. PUB. L. 191, 191–92 (1959) (arguing that society’s “collective responsibility for sickness and injury” and its “modern” systems of sharing the cost of social risks warrants public provision of assistance for victims); Arthur J. Goldberg, Equality and Governmental Action, 39 N.Y.U. L. Rev. 205, 224–25 (1964) (arguing that government should compensate crime victims because crime reflects society’s inattention to poverty and social injustice).

\(^{266}\) See Fry, supra note 265, at 192–93. See also Bentham, supra note 265, at 39 (arguing that while the best source of compensation for losses resulting from crime is the offender, the cost of losses that the offender cannot pay should be borne by the state because “it is an object of public benefit; the security of all is concerned”); Childres, supra note 265, at 457–59 (referencing the failure of private insurance in the workers’ compensation context to conclude that victim compensation should be funded by the state).

\(^{267}\) See Philip J. Cook & John MacDonald, The Role of Private Action in Controlling Crime, in CONTROLLING CRIME: STRATEGIES AND TRADEOFFS 349–51 (2011) (discussing how victim compensation programs can, in conjunction with other programs, enhance deterrence by increasing cooperation by victims); Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. POL. ECON. 169, 176–79 (1968) (modelling criminal behavior as a balancing of the benefits of a crime against the probability of being detected and the penalties imposed upon detection); Gary S.
defendant fines and fees comprise funds used to pay victims, the size of the penalty paid by criminals is increased. However, it is hard to imagine that these additional monetary amounts recovered through supplementary fines, fees, and restitution would be substantial enough to effect any marginal change in offender behavior. But even if the amount of the penalty (conditional on conviction) remains relatively unchanged, the probability of detection and conviction of criminals may be increased if victims are more likely to come forward and cooperate with law enforcement officials, knowing that they may receive some sort of monetary compensation. Whether compensation programs can in practice achieve this goal is an open question, given the limited size of the awards received by victims under these programs. This second set of justifications for victim compensation programs appears more compelling in the context of securities fraud, and its implications will be discussed in more detail later in this Article.

3. An Economic Assessment of Securities Restitution Funds

a. Effect on Investor Behavior

i. Moral Hazard: Will Investors Be More Likely to Take Unnecessary Risks?

Even though the securities restitution funds are not technically insurance programs, they arguably raise moral hazard concerns in a manner that victim compensation programs do not. One may worry

Becker & George J. Stigler, Law Enforcement, Malfeasance, and the Compensation of Enforcers, 3 J. LEGAL STUD. 1, 4 (1974) (“Enforcement is generally more effective against violations with victims because victims have a stake in apprehending violators, especially when they receive restitution.”).

268. The congressional findings accompanying the final version of VOCA highlighted Congress’s hope that the compensation program would promote victim cooperation. The Victims of Crime Assistance Act of 1984: Hearing on S.2423 Before the Senate Comm. on the Judiciary, 98th Cong. 9–10 (1984).

269. See, e.g., Charlene L. Smith, Victim Compensation: Hard Questions and Suggested Remedies, 17 RUTGERS L.J. 51, 69–70 (1985) (arguing that economic incentives do not appear to provide adequate incentives for victims to cooperate); Goldscheid, supra note 261, at 217 (noting that “the modest amount of available awards and the relative lack of awareness of the programs among victims” may explain why programs may not have a “substantial impact on victims’ willingness to cooperate with law enforcement”). These type of problems could similarly hinder the potential effectiveness of securities restitution funds.

270. See infra section II.B.3.a(2).

271. This is in part due to the non-monetary nature of the victim’s loss in the latter. Would someone take fewer precautions because of the prospect of partially recovering some of the monetary losses associated with a crime?
that investors who are aware of the existence of a securities fraud restitution program may take unnecessary risks (or risks they would not otherwise take) in search of a high return by investing in speculative and dubious investments, knowing that if things turn out well they will earn a high return but that if things do not they are likely to receive some partial recovery from the fund. In the context of small, private securities offerings, moral hazard can present greater concerns relative to transactions in the public secondary markets. Providing incentives to investors to protect themselves against fraud in the public markets (e.g., by double-checking and fact-checking companies’ reports and regulatory filings) could result in wasteful and duplicative expenditures. However, in the smaller, private transactions that are the subject of this Article, society may prefer investors to be more skeptical and carefully conduct adequate research to protect themselves before purchasing securities.

In practice, however, moral hazard is unlikely to pose a significant problem in this context. First, for moral hazard to become a concern, you need individuals to be aware of the terms of the restitution programs beforehand and be somewhat certain that they will have a right to recover from the fund. Moreover, as noted earlier, the insurance market minimizes the impact of moral hazard on individual behavior by making the insured bear part of the loss, often via deductibles, copayments and maximum recovery caps.272

As designed, the Montana and Indiana restitution funds possess all these mechanisms. Prior to bringing a claim, an investor must have a judgment against the individual who violated the securities laws and must show that such judgment cannot be satisfied.273 Thus, the investor must either bring a lawsuit against the violator or convince the securities administrator to bring a civil or administrative action against the perpetrator and cooperate with such investigation. Requiring the investor to make these monetary and non-monetary outlays prior to bringing a claim against the fund serves as the functional equivalent of a deductible. And, even after the investor properly files a claim against the restitution fund, the investor is only entitled to partial recovery and will have to absorb a substantial portion of the losses. In Montana, for example, the investor must bear twenty-five percent of his or her losses up to $100,000 and 100 percent of the losses beyond that (as the maximum recovery is $25,000).274 And, in Indiana, investors seeking

272. See supra note 252 and accompanying text.
273. See supra notes 207, 214 and accompanying text.
274. See supra notes 214–17 and accompanying text.
compensation still have to bear twenty-five percent of their losses up to $60,000 and 100 percent of the losses after that (as the maximum recovery is $15,000). It thus seems unlikely that recovery under these programs will incentivize investors to undertake excessive risk.

ii. Enhanced Cooperation of Fraud Victims with Securities Administrators

By providing monetary incentives to encourage injured investors to come forward and notify the securities administrators of a securities law violation, restitution programs may affect investor behavior in a manner that is desirable from society’s perspective. As noted earlier, in securities fraud cases involving small monetary amounts, investors may not have the incentive to bring a lawsuit. This is an undesirable outcome as there are positive externalities associated with private securities fraud lawsuits. For example, by increasing the expected penalties for fraudsters, lawsuits serve a deterrent effect. In addition, the filing of a private lawsuit can also alert the securities administrator, who can then investigate and further penalize the securities violator.

As is the case with many activities that produce positive externalities, investors may not bring lawsuits or file complaints at a socially desirable

275. See supra notes 203–08 and accompanying text.
276. To place these recovery amounts in perspective, we can compare these to the actual losses suffered by investors in these fraudulent schemes. As noted earlier, the first payment from the Indiana Securities Restitution Fund, in the amount of $15,000, was awarded to an investor who had lost $400,000. See supra note 211. On February 2015, several Indiana investors who lost their life savings in a series of Ponzi schemes received restitution payments from the fund. See Press Release, Ind. Sec. State, Secretary Lawson Awards Over $150,000 in Securities Restitution Funds to 14 Hoosier Investors Robbed of Retirement (Feb. 17, 2015), http://www.in.gov/activecalendar/EventList.aspx?public&eventidn=209051&view=EventDetails&information_id=211275&print=print [https://perma.cc/J5N3-ACQM]. In one of these schemes, thirty investors lost $1.4 million (about $46,666 on average). See Press Release, Ind. Sec. State, Indianapolis Man Sentenced to 10 Years for Running a Ponzi Scheme (Oct. 22, 2014), http://www.in.gov/activecalendar/EventList.aspx?view=EventDetails&eventidn=190303&information_id=207219 [https://perma.cc/N6ND-J6EY]. More recently, the Indiana fund made restitution payments to a number of investors who were victims in a real estate development fraudulent scheme. See Press Release, Ind. Sec. State, Victims of Securities Fraud Receive $62,500 in Restitution Fund Awards from the Indiana Secretary of State’s Office Made Possible by the Secretary of State’s Securities Restitution Fund (Nov. 17, 2016), http://www.in.gov/activecalendar/EventList.aspx?public&eventidn=254286&view=EventDetails&information_id=252912&print=print [https://perma.cc/A57M-HTLF]. In this scheme thirty-six investors lost $2.18 million (an average of just over $60,000). See Bob Kasarda, Pair Ordered to Pay Back $2.1 Million in Porter County Investment Scam, THE TIMES OF NORTHWEST INDIANA (Sept. 26, 2016), http://www.nwitimes.com/news/local/porter/pair-ordered-to-pay-back-million-in-porter-county-investment/article_865630f1-376b-5c9d-90eb-a35d3af1f5a.html [https://perma.cc/YPSG-EYJ4].
277. See supra notes 68–69 and accompanying text.
level if in doing so they have to bear the costs (monetary and otherwise) without receiving a sufficiently large benefit in return, even if the social benefits of their actions would far outweigh their private costs. By providing investors a larger return to filing a lawsuit in court or a complaint with state securities regulators, restitution programs may align private and social interests and enhance the deterrent effects of the securities laws. Such effect on investor behavior would certainly be greater in those states that also allow the securities administrator to order restitution on behalf of the investor at the conclusion of an administrative action, as the upfront costs for the investor are lower.

b. Fiscal, Monetary, and Distributional Concerns

i. Are Securities Restitution Funds Too Small to Meet Their Goal?

One concern is whether the amounts that investors may recover from the funds are large enough to compensate investors and encourage them to assist securities administrators in the detection and investigation of securities fraud. Consider an investor who lost $40,000. Under either the Montana or Indiana program, the maximum recovery for this investor would be $10,000 (i.e., twenty-five percent of the investor’s losses). Certainly, $10,000 is much less than $40,000, and one wonders to what extent the investor will be able to recover financially from the unfortunate event. Moreover, if the amounts that an investor can recover from the fund are not large enough, the investor may not have the incentive to pursue a case in court or cooperate with the securities administrator. This problem is amplified by the fact that the partial recovery of $10,000 is uncertain (e.g., the action may be unsuccessful or the fund may run out of money), further reducing the expected compensation for the investor.

There are some obvious problems with granting larger awards. Providing investors with higher levels of compensation may exacerbate the moral hazard problem outlined earlier. Though this may be true for any increases in the percentage of losses that may be recoverable and for the savvier investors, it is not clear whether increasing the maximum cap (currently $25,000 in Montana and $15,000 in Indiana) would have such


279. See supra notes 208, 217 and accompanying text.
detrimental effects on investors’ \textit{ex ante} behavior.\footnote{280} A more pressing concern is that providing higher levels of compensation would demand more funding, as it would drain any available funds more quickly. Because the restitution funds are not financed with tax revenues, this is likely to result in shortfalls, leading to increasing delays and lower levels of compensation for injured investors.\footnote{281}

One possible strategy that may allow for more sizable recovery amounts while avoiding budgetary shortfalls would be to have claims against the funds be means tested like some victim compensation programs.\footnote{282} For example, one could imagine a system where only persons with income below a certain level may fully recover the maximum statutory amount. For those investors with annual incomes above this threshold, the amount that may be recovered from the fund would be phased out gradually. This system would promote one of the goals of the restitution funds—provide compensation to investors, particularly those less wealthy individuals, who are the ones more likely to be hurt by a small financial loss.\footnote{283} The drawback, however, is that those individuals who cannot recover from the fund would have fewer monetary incentives to bring a lawsuit or alert the administrator to the securities fraud (though non-monetary factors such as quenching a thirst for revenge would still provide some incentives to report to the administrator).\footnote{284} Eligibility could be based on non-monetary factors, such as membership in groups seen as easy targets by fraudsters. Montana has adopted a similar strategy by increasing the amount of money that may be recovered by “vulnerable” individuals (including, for example, senior citizens) to the lesser of $50,000 or fifty percent of the amount of unpaid restitution.\footnote{285}

280. \textit{Id.}
281. \textit{See supra} notes 209–10, 219–20 and accompanying text. This concern likely led to Montana’s legislation which expanded the source of funding for the restitution programs a few years after its establishment. \textit{See supra} note 220 and accompanying text. A fiscal note accompanying the Montana bill estimated that annual revenues from the additional funding sources would equal approximately $272,000.
282. \textit{See supra} notes 228–29 and accompanying text.
283. Moreover, to the extent these investors are less savvy, the impact of moral hazard on their behavior is likely to be relatively attenuated.
284. This concern may be lessened if wealthier individuals have the resources and incentives to bring a private lawsuit regardless of their ability to recover from the fund.
285. \textit{See supra} note 218 and accompanying text.
ii. Opportunity Costs & Distributional Concerns

In assessing the social welfare consequences of establishing a restitution fund, one must consider more than just the direct costs and benefits associated with such a program. In a world of limited and scarce resources, undertaking a new program sponsored and funded by the government often means that the state must reduce the size of other programs or maybe even abandon some programs altogether. This section considers two general types of programs that may be adversely impacted by the introduction of securities restitution funds: fraud prevention activities conducted by securities administrators and programs unrelated to the securities regulation area.

If the funds devoted to a new restitution program would have remained within the administrative agency’s budget (instead of being remitted to the state’s general treasury), one may worry that the newly created funds would receive monies previously earmarked in the administrator’s budget for essential areas such as securities enforcement or investor education programs. To the extent that enforcement activities can generally result in the recovery of funds (via fines or settlements for example) for the administrator, one may not expect their levels to be affected by the introduction of the restitution programs. However, investor education programs, which are not revenue generating, may be adversely affected.

In fact, many state securities administrators use investor education programs as part of their toolkit in combating fraud.286 These programs generally prepare informational materials and engage in outreach events (such as presentations) to teach individuals about investing strategies and how to avoid falling victim to fraud.287 Most of these programs, including Indiana’s, are funded in part by funds collected from settlements in securities fraud cases litigated by the securities administrators (i.e., those being partially diverted to restitution funds).288 One may wonder whether the money diverted to the restitution funds should rather be invested in these types of preventive programs. Although these programs are certainly an important part of the securities administrators’ toolkits to combat fraud, their effectiveness is still an

288. Id.
open question in light of the particular groups that are often victimized, and behavioral limitations in human decision-making. Though an assessment of alternative fraud-preventive programs relative to restitution funds is beyond the scope of this Article, it should be acknowledged that by adopting an investor restitution program, a state is affirmatively choosing among different strategies to combat fraud.

If the amounts deposited in the restitution fund come from the state’s general fund or from a source that would have otherwise gone to the general fund, then the social calculus must also consider the opportunity costs of such a transfer (i.e., the alternative use of the money in the provision of other government programs that has been foregone) and the resulting distributional effects. This concern gains greater prominence in an age of budget deficits and cuts to education and health programs. As an illustration, we can briefly examine the general appropriations in Indiana’s 2016 budget. The two major components of this part of the state’s budget are K-12 education (forty-six percent) and Medicaid (thirteen percent). Arguably, a dollar spent to provide restitution to a defrauded investor is a dollar that cannot be spent on K-12 education, providing healthcare to those in need, etc. But determining the distributional effects certainly is not as easy as that. Perhaps this dollar (or a portion of it) would have stayed in the state administrator’s budget. Or even if it had gone to the general revenue, the dollar may have been spent in programs less commendable than K-12 education and health care for the poor. In any event, in addressing these distributional concerns, the identity of the securities restitution fund recipients also matters, as many of these (such as the elderly) may otherwise be the recipients of aid from the state. Ultimately, these are all issues for state legislatures to consider and weigh. But at the very least, these concerns


290. This is a concern even for programs funded with fees obtained by the securities administrators from brokers and investment advisors. Generally, these funds are used to finance essential programs, offset funding shortfalls and remitted to the state’s general treasury.


292. Id.
stress once again the importance of considering some sort of means testing and lend additional support for a system that focuses on a vulnerable portion of the population.\textsuperscript{293}

c. Jurisdictional, Transactional, and Residency Requirements

The long-term success of these investor restitution programs may be determined not just by the amount of the recovery provided to injured investors, but also by the strictness of their eligibility requirements. For example, Montana’s restitution program provides a higher maximum recovery than Indiana’s, but it is more restrictive in other key dimensions. First, Montana’s restitution fund only covers violations of Montana laws and regulations, while Indiana covers not only violations of Indiana laws and regulations, but of federal violations as well.\textsuperscript{294} Second, while an investor seeking to establish a claim against the restitution fund in Montana must have an order from the Montana securities commissioner or an order from a Montana court requested by the commissioner, Indiana only requires that the investor have a court order or an administrative order.\textsuperscript{295} Finally, while only Montana residents are eligible under that state’s restitution fund, Indiana provides coverage to non-resident investors from states that afford analogous protection to Indiana residents.\textsuperscript{296}

Having greater flexibility in jurisdictional, transactional, and residency requirements will likely make any single investor compensation program more expensive, as more investors will be able to file claims for restitution. However, more flexible requirements (such as those in Indiana’s program) could lead to a more widespread adoption of these programs, as states seek to establish reciprocity with each other, and promote future cooperation on this front. Conceivably, one could envision states cooperating in administering common securities restitution funds, further spreading the risks and costs associated with these programs.\textsuperscript{297}

CONCLUSION

Although often overlooked in the academic literature and financial press, small-scale securities fraud can have devastating consequences for the most

\textsuperscript{293} See \textit{supra} notes 282–85 and accompanying text.

\textsuperscript{294} See \textit{supra} notes 203, 215 and accompanying text.

\textsuperscript{295} See \textit{supra} notes 204, 214 and accompanying text.

\textsuperscript{296} See \textit{supra} notes 205–06, 216 and accompanying text.

\textsuperscript{297} This parallels an earlier recommendation in this Article calling for increased cooperation among states in establishing and administering specialized administrative courts. See \textit{supra} notes 182–84.
vulnerable of investors—those who may be more susceptible to becoming victims in the first place and who stand to lose a significant share of their life savings. Traditional enforcement mechanisms at the federal level often fail in these cases, making state law and enforcement indispensable. And with the continuing trend of deregulation at the federal level and an ever-overburdened SEC, state regulators must assume an even greater role in protecting local investors.

States are responding to this challenge, and this Article highlights two innovative strategies developed by different states to protect investors. The first, granting state securities administrators the power to order restitution on behalf of injured investors, has been slowly developing for decades and has by now been adopted by almost half the states. The second strategy, establishing restitution funds to assist investors in their recovery, is at a more nascent state and has only been fully implemented in two states. These two strategies can complement each other. An injured investor can notify the securities administrator of a securities violation; wait for the administrator to initiate administrative proceedings and order restitution; and then file for a claim against the fund if the violator does not satisfy the administrator’s order.

These developments are without doubt encouraging, but there remains work to be done. More states should authorize their administrators to grant orders of restitution in cases involving securities fraud. Increased cooperation and coordination among the states in establishing and maintaining specialized administrative courts should facilitate this process. The securities restitution funds established in Indiana and Montana are novel and intriguing ideas. Whether these programs can be successful is an open question, but there is plenty of room for improvement and optimism. Adjusting the size of awards by imposing a “means-testing” on investor recovery could address both fiscal and behavioral concerns. Allowing out-of-state investors to recover could lead to more widespread adoption of these programs and encourage cooperation among state securities administrators.

Although these legislative advances appear to further the goals of compensating injured investors and deterring untoward behavior, they cannot be considered in a vacuum. This Article stressed the importance of understanding the effect of these strategies on the behavior of investors and administrators and how behavioral changes by these actors could have both positive and undesirable consequences. Gaining this understanding is critical for the design of successful programs and institutions that will both deter securities fraud and compensate its victims in a cost-effective manner.
APPENDIX

Table 1: Authority of Administrator to Request Restitution in a Civil Action or Order Restitution in an Administrative Action

<table>
<thead>
<tr>
<th>State</th>
<th>(1) Can Administrator Request Restitution?</th>
<th>(2) Can Administrator Order Restitution?</th>
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### Table 2:
**Authority of Administrator to Request Restitution in a Civil Action or Order Restitution in an Administrative Proceeding**

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<th>Code Section Re: Administrative Actions</th>
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