

Senate Bill 2011

Testimony of North Dakota Securities Commissioner Karen Tyler

Before the Senate Appropriations Committee

January 4, 2023

Mr. Chairman and Members of the Committee, good afternoon. I am Karen Tyler, the State Securities Commissioner. It is a pleasure to share some time with you today to discuss the budget appropriation for the North Dakota Securities Department, and to answer any questions you may have regarding the Department's budget request.

STATUTORY RESPONSIBILITIES

The Securities Department is a regulatory agency that serves the citizens of North Dakota through the administration and enforcement of the North Dakota Securities Act (10-04), the North Dakota Commodities Act (51-23), the Franchise Investment Law (51-19) and Pre-Need Funeral Services Law (43-10.1).

REGULATORY POLICY OBJECTIVES AND FUNCTIONS

The primary regulatory policy objectives of the Securities Department are investor protection and the support of legitimate capital formation. We execute on those objectives through our work in following areas:

- 1) We regulate the capital formation and franchise registration process.
- 2) We register, and regulate the conduct of, securities industry firms and professionals who want to do business in the state.
- 3) We perform conduct focused examinations of broker-dealer and investment adviser firms and professionals.
- 4) We investigate investment fraud and take enforcement actions as necessary and appropriate, and we also make criminal referrals and support criminal cases. The majority of our resources are dedicated to this enforcement function.
- 5) We produce and deliver investor education and financial literacy programs.

The North Dakota Securities Department is a small agency, with 10 full time employees. No additional FTEs are requested in our 23-25 budget. The Department's organizational chart is included in your copies of this testimony.

BUDGET REQUEST

The Securities Department is a revenue generating, special fund agency. The Department's total budget request for the 2023-25 biennium is \$3,324,894. This breaks down as \$2,418,464 for the Salaries and Wages line item, and \$906,430 for the Operating line item.

The changes requested from the Base Level budget are as follows:

1. the enhancements set forth in the Governor's executive budget for salary and benefit adjustments which total \$204,583
2. in the operating line, funding to cover increased IT and audit costs, estimated at \$25,000 for the biennium – over the last 2 budget cycles we have had IT related cost increases that we were informed of after the submission of our budget, and we have also been informed that the cost of our audit this biennium will be an estimated \$8,500.

3. also in the operating line, an increase to fund the expense of blockchain and cryptocurrency related investigations analytics, estimated at \$135,000 for the biennium.

The Department seeks funding to purchase licenses for blockchain analytics software from a private sector data analytics company, or contract with private sector analytics service providers. This will improve the Department's ability to conduct Digital Asset and Decentralized Finance related investigations, and enable the tracking of cryptocurrency transactions between digital wallets and intermediaries, improving the likelihood of asset seizure and return of funds to harmed investors.

4. and one time funding in the operating line of \$150,000 for the enhancement of two technology systems related to investigation and examination case management, and our securities filing portal. The enhancements will provide an interface between the two data management systems, expand the functionality of the filing portal, and allow for secure and efficient electronic submission of investor complaints, which will improve the citizen user experience. Measurable outcomes of this investment include an increase in number of examinations conducted by the Department, a reduction in exam turnaround time, improvement of

enforcement case outcomes, improved speed of case analysis and resolution, and improved speed of securities filing processing and approvals.

DEPARTMENT REVENUE

The Securities Department is a revenue generating agency for the state, taking in over \$22.3 million dollars in revenue last biennium, and we are on-track to exceed \$23 million in the current biennium. Over the last several budget cycles, the Department has spent approximately 10 to 12 cents per revenue dollar generated. Attached to my testimony is an infographic that includes a 20 year look back for total revenues, total expenditures, and net total deposited to the general fund. The net number is over \$170 million.

Because our budget is funded by the revenue we generate, I'd like to take a minute to review our revenue sources, notable changes, and our projections for the upcoming biennium.

REVENUE SOURCES

The majority of the Department's revenue is generated in two categories - from securities registrations and filings, and from the registration of investment

industry firms and professionals. A small percentage of our revenue is derived from franchise registrations, and we may also generate revenue from civil penalties assessed by the Commissioner. Approximately 98% of the Department's revenue comes from out of state.

Securities Filings

Examples of types of securities registrations and filings that generate revenue for the Department would be Mutual Fund notice filings, Unit Investment Trust notice filings, Non-traded Real Estate Investment Trust registrations, and small business capital formation filings to either register securities or qualify for an exemption from registration.

A 3 year look-back for filings from North Dakota businesses seeking to raise capital through a securities offering shows 71 companies filing to raise approx. \$1.455 billion dollars, with businesses representing diverse industry sectors of Health, Hospitality, Energy, Technology, Agriculture, Real Estate, and Finance.

Industry Registration

Investment industry registrations include broker-dealer and investment adviser firms, and their registered professionals – defined in the Securities Act as securities agents and investment adviser representatives.

For the number of investment industry firms and professionals doing business in the state of North Dakota, an industry registration snapshot as of the end of December shows:

1,179	Broker-Dealers
114,396	Broker-Dealer Agents
873	Investment Advisers
1,681	Investment Adviser Reps

Industry firms and professionals must make an initial registration filing and then renew each year. The annual renewal of these industry registrations takes place at the end of December. For the 2023 renewal cycle, a new record total of 118,129 registration renewals were completed in an entirely automated process, through our registration system called the Central Registration Depository (CRD), and a payment of just over \$7.2 million was collected for the 2023. This renewal process occurs at no cost to the state.

CRD is both a registration system and a comprehensive data depository, holding important information about all the investment firms and professionals operating in the investment industry in the US. The data in the CRD is used by regulators and the industry, but it is also available to the public to assist them in evaluating the background of a firm or professional under consideration for providing services.

2023-2025 Revenue Projections

Looking ahead, given the strong increase in industry registration growth this biennium, we are increasing our revenue projections for the upcoming biennium to \$23 million. Most of this growth is occurring in the Broker-Dealer Agent category of registrants, with a 2022 growth rate of 15% year-over-year.

MISC ITEMS

There are no other sections included in our budget bill and the Department did not have any one-time funding items in the current biennium.

There were no financial audit findings in the Department's last audit, for which the audit period was July 1, 2018 - June 30, 2020.

At this time I am not aware of any other bills being considered by the Legislative Assembly that would have an impact specific to the Securities Department budget.

The Department does not receive any federal funding and there was no fiscal recovery funding appropriated to the Department during the 2021 special session.

FOCUS INITIATIVES

Launch of Electronic Securities Filings

Last session I provided an update on the Department's progress in migrating to a fully electronic securities filing system. This work began on a small scale during the 2017-2019 biennium, accelerated significantly as a result of the pandemic and the enhancements to the Electronic Filing Depository, and the transition took a major step forward to completion with the launch of our new Securities Filing Portal in November of 2021.

Many of our securities filing types now move through a technology system called the Electronic Filing Depository (EFD). The system is very close to operating at full capacity, with only one more filing type to be migrated, and it is anticipated that 95% of our securities filings, numbering approximately 25,000/year, will

ultimately be made through the system. Franchise filings are also made through the EFD.

All fees associated with these filings, which make up approximately one-third of the Departments annual/biennial revenue, are also collected through this system, and it creates significant efficiencies for both issuers of securities and for the department. Our national organization (NASAA) funds the development and support of the EFD, and it is utilized at no cost to the state.

In 2021 the Department developed and launched our Securities Filing Portal to facilitate the electronic filing of all remaining securities filing types, many of which are utilized by North Dakota businesses relying on certain registration exemptions in order to raise capital from investors.

As a result of the development of these electronic filing systems, the Department does not receive any paper filings, and all fee payments are made electronically.

Fintech Focus

Financial Technology innovations, and the benefits and risks created by these innovations, remain a primary focus for the Department. These financial products and services present new regulatory challenges, and they include but are not limited to robo-advisors, app-based stock trading platforms, crowdfunding

platforms for capital formation by start-up companies, cryptocurrency and digital or crypto asset derivative products, digital asset intermediaries, crypto interest accounts, and securities token offerings which are a new approach to raising capital.

Enforcement

Related to our focus on fintech, the Department has seen and anticipates continued growth in Social Media driven investment fraud as well as fraud related to cryptocurrency. Social media platforms and dating websites and applications are proving exceptionally fertile ground for financial criminals to exploit victims and steal money. Two areas of continued heightened concern:

- 1) Social platforms are commonly used to perpetrate investment fraud related to certain stocks and digital financial instruments such as securities tokens and cryptocurrency. The frauds may be pushed through discussion communities and apps like reddit, quora, medium and telegram, and the fake businesses will also have a more mainstream social presence like facebook and twitter. Financial criminals can easily establish highly convincing fake profiles, connect to potential victims through common interests, and extract personal information after establishing a relationship

– this is leading to an increase in “romance scams”, and of particular concern is that as seniors become more comfortable with these social sites, apps and services, they also become more easily targeted.

- 2) Financial criminals can also easily and convincingly establish fake companies, websites and cryptocurrency trading platforms on the internet. Social media hooks are used to push victims to the trading platforms. A typical fraud formula is to give the victim a period of trading success and get them to add money to their account and trade more. Eventually when a victim tries to withdraw funds, they are told they have to pay taxes and fees with new money before they can access their gains. The victim then adds more money to their account and continues unsuccessfully to attempt to withdraw funds. Eventually the account is drained by the financial criminals.

Examination System/Industry Outreach

Supported by our new case management system, in early 2021 the Department launched a new approach to managing examinations of investment industry firms and professionals, with an enhanced focus on state registered investment adviser

firms. In August of 2022 we also published a comprehensive regulatory guidebook for state registered IAs as a resource for their compliance programs and professionals to help facilitate understanding of and compliance with state securities laws and rules.

It was through this new examinations program that the Department uncovered what is the largest and most complex enforcement matter we have dealt with in the last 20 years, and it is stark reminder to all of us dedicated to the mission of investor protection, just how important our regulatory programs are in a capital market system that, while creating opportunity for wealth creation, also comes with the tradeoff of risks that are carried almost exclusively by the investor.

This case involves over 140 victims, and thus far, approximately \$50 million in potential damages for the harmed investors. Several orders have been issued and the investigation is ongoing.

Focus on Seniors

In the 2017 Legislative Session, the legislature passed a law to strengthen protections for seniors and vulnerable adults who may be targeted for financial exploitation. Section 10-04-08.5 of the Securities Act requires brokerage firms and investment adviser firms to report to the Securities Department and Adult

Protective Services if they believe a client is being financially exploited, and provides the firms the ability, with indemnity, to withhold distribution of funds. The Department will continue its outreach and education initiatives to improve industry awareness regarding the law and their obligations under it.

Workforce Transitions

After years of low turnover, our Department has entered a retirement cycle, and we continue to work through key retirement transitions. In the last 6 years, we have had 115 years of experience retire, and this year we will see the retirement of our exceptionally talented, highly experienced attorney who has been practicing law for 42 years, 16 of which will have been with the Department upon his retirement.

To effectively manage the transition in this very esoteric area of law, we have held open 2 FTE positions and utilized temporary team members in order to create capacity in our salaries budget and hire our new attorney as early as possible.

This approach has been necessary to best facilitate the transfer of institutional knowledge and we are capturing as much benefit as possible from having our new attorney train with our outgoing team member. While not ideal from an overall

staffing standpoint, the attorney transition is going very well, and overall as we have managed through these retirements over the last 6 years, the Department has been very successful in hiring outstanding new team members as we execute on our succession planning and workforce transitions.