CHAPTER 1
Regulation

SECURITIES AND THE PUBLIC INTEREST

A law-making body such as Congress or a state legislature has the constitutional authority to regulate commerce in the public interest. That includes the regulation of securities, securities markets, and securities transactions. The law-making body:

- Formulates regulatory objectives and approves securities laws;
- Creates a securities-regulation agency;
- Assigns responsibility and delegates authority to that agency as the primary administrator of securities laws;
- Provides financial and legal support for the agency's continuing operations; and
- Monitors the agency's administration of securities laws.

Securities laws are codified as amended in the government's general and permanent laws, which are available to the public in printed form and from government and private-sector Web sites.

In addition to delegating institutional authority to the securities-regulation agency, the law provides a structure by which that entity is governed by natural persons appointed for fixed terms of office. Appointees and persons employed by the securities regulator are prohibited from engaging in any business and prohibited from participating in some securities-related activities regulated by the agency.

The securities-regulation agency establishes regulations for the purpose of administering the securities law. These regulations are codified as amended in the government's regulations, which are available to the public in printed form and from government and private-sector Web sites.

The agency enforces regulations:

- Directly;
- Through one or more self-regulatory organizations;
- Through the courts; and
- By cooperation with other government agencies and departments, domestic and foreign, which administer securities laws and nonsecurities laws.

The structure of laws, regulations established by the securities-regulation agency, and rules established by self-regulatory organizations is shown in Exhibit 1.1.

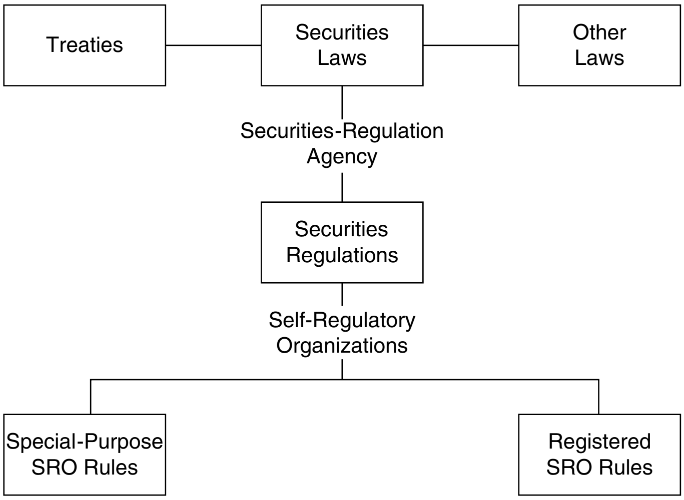

EXHIBIT 1.1 Structure of Securities Laws and Regulations

Securities, markets, and transactions are part of a private-sector process called capital formation. Capital formation results in investments that are essential for economic growth. The current income and accumulated wealth produced by a growing economy increase the standard of living for a country's population. Income and wealth are taxed to pay the expense of government. There is a public interest in the cost efficiency and effectiveness of capital formation.

There also is a public interest in government-securities markets: public primary markets in which governments sell debt securities and public secondary markets in which these securities are bought and sold prior to maturity. The ability of governments to borrow money and the cost of borrowing are affected by the efficiency and effectiveness of these markets.

Government regulation is a political response to the real or perceived failures of markets to serve the public interest. Regulation also may be used to promote or protect special interests by means that are not compatible with efficient capital formation. All politics are local, but capital formation is national and international.

Effective regulation in the public interest requires:

- Law-making and regulation-making processes that are efficient and open to public participation;
- Efficient administration of the securities-regulation agency;
- Access to the courts for entities and natural persons affected adversely by questionable laws and regulations; and
- A competent and independent judiciary.

There is a cost for the regulation of securities, markets, and transactions. Most of that cost is for information-processing systems and the salaries and related expenses for people. Some people are employed by government to formulate and administer laws and regulations. Others are employed by private-sector entities, such as broker-dealers and the issuers of securities, to ensure compliance with laws and regulations. In addition, significant costs are incurred by the private sector for the services of attorneys and public accountants because these services are required, directly or indirectly, by the law. Ultimately, these costs are paid by the owners of securities. High costs are a barrier to effective capital formation.

[Notes 1–4]

MEANING OF ''SECURITY''

The authority of a law is based on definitions and descriptions of what is or is not within the purpose or scope of that law. The scope of a securities law is established in part by the law's definition of the word "security." The law regulates financial assets, which are defined as securities, but the law does not apply to financial and other assets not defined as securities. The law also defines or describes securities transactions that may or may not be regulated.

A security is what the law defines a security to be. Definitions of "security" are established and amended by the law-making bodies. These definitions are interpreted by the securities-regulation agency and by the courts. Definitions are added and amended from time to time, and interpretations evolve as new forms of securities, markets, and transactions are created by competition and innovation.

Securities laws usually define a security descriptively as a bond, note, stock, or an option. Descriptive definitions use all-purpose words, such as "evidence of indebtedness," to describe the general form of a security. Descriptive definitions have two weaknesses:

1. They do not identify the essential qualities of a security.
2. They require ever more specific definitions of "bond," "note," "stock," and "option" as new forms of securities are created.

The use of descriptive and all-purpose words to define a security and to establish the scope of a securities law is a practical approach to regulation. In some situations, however, these words are not adequate and the meaning of the law must be interpreted by the courts. For more than 60 years, the courts have used the concept of an investment contract as the test of whether a specific bond, or note, or stock is regulated by the law.

Generally, an investment contract exists when:

An entity or a natural person commits money or other value

To provide capital for a common enterprise

With an expectation of receiving profits

From the efforts of others.

The profits from an investment contract include but are not limited to:

- Money paid by an issuer as interest to the owners of its debt securities;
- Money paid by an issuer as dividends to the owners of its equity securities;
- Money representing an increase in the value of a security realized when the owner sells the security to the issuer or a third party; and

- Money representing an increase in the value of a debt security realized by the owner when the security's maturity amount is paid by the issuer.

An investment contract that is a bond, note, or stock is usually a security regulated by the securities law.

[Notes 5–9]

DEBT, EQUITY, AND OPTION SECURITIES

Most securities can be categorized as debt, equity, or option; however, some debt securities are convertible into equity securities, some equity securities have debtlike characteristics, and options may grant the right to buy or to sell a debt security or an equity security.

The property rights of debt, equity, and option securities may be transferred from one owner to another owner by the sale of these securities in private-market or public-market transactions.

Debt Securities

A debt security called a bond or a note is an obligation to pay money. The terms and conditions of a debt security are authorized by the constitutional documents of the entity that issues the security and described by an indenture document prepared by the issuer. The money received by the issuer from the sale of a debt security is time-limited capital for the issuer. The owners of a debt security are creditors of the entity that issued the security. The market value of a debt security, which may fluctuate, is determined by the issuer's obligations to make money payments in the future.

The issuer of a debt security:

- Is obligated to pay the maturity-value amount of the security to the current owners no later than the security's maturity date, and
- May be obligated to pay fixed or variable amounts of interest periodically to the current owners.

The payments required by a debt security are usually general obligations of the issuer; however, the payment obligations of some bonds and notes may be secured by specific property of the issuer or may be guaranteed by an entity other than the issuer.

The rights of debt-security owners are created by the issuer. The rights of one debt security may be subordinated to the rights of other debt securities issued by the same entity.

Equity Securities

An equity security called a stock or the shares of a stock is a right to participate in the income from property and the distribution of property. The terms and conditions of an equity security are authorized by the constitutional documents of the entity that issues the security and described by an offering document prepared by the issuer. The money received by the issuer from the sale of an equity security is permanent capital for the issuer. The owners of an equity security are owners of the entity that issued the security. The market value of an equity security, which may fluctuate, is determined by expectations of the issuer's profitability in the future.

The issuer of an equity security:

- If common stock, is not obligated to pay money dividends to the current owners of the stock. Common stock has no maturity date or maturity value, and the issuer has no obligation to buy the security from the owners.
- If preferred stock, usually is obligated to pay money dividends periodically to the current owners of the stock. Some preferred-stock issues are convertible into common stock. Preferred stock has no maturity date or maturity value, and the issuer may or may not have an obligation to buy the security from the owners. A preferred stock is a claim to the assets of the issuer that ranks higher than the claim of common stock but lower than the claim of any class of debt security.

The voting rights of equity-security owners are created by the issuer. The voting rights of one class of equity security may be different from the voting rights of other classes issued by the same entity.

Option Securities

An option is a ''call'' or a ''put.'' Every option has one issuer and one owner. The owner of a call option has the right (but no obligation), after paying the option price, to buy an amount of a given security from the call issuer at a fixed price before or on the option's expiration date. If and when the owner exercises the option, the issuer of that option has an obligation to sell the agreed amount of the security to the option owner at the agreed fixed price.

The owner of a put option has the right (but no obligation), after paying the option price, to sell an amount of a given security to the put issuer at a fixed price before or on the option's expiration date. If and when the owner exercises the option, the issuer of that option has an obligation to buy the agreed amount of the security from the option owner at the agreed fixed price.

The security that may be bought or sold by the exercise of an option is called the ''settlement'' security to distinguish that security from the option, which is a separate security.

The market value of an option security, which may fluctuate, is determined by the terms and conditions of the option. These terms and conditions are:

- Agreed by issuers and buyers in dealer-market transactions,
- Accepted by third-party buyers in dealer-market transactions,
- Described by issuers in a prospectus when the option is offered in a public market, or
- Stated in the rules of an exchange when a standardized option issued by a settlement facility is listed by that exchange for trading.

The purpose of issuing an option is to create obligations and rights, not to acquire capital.

The current owners:

- Of a call option to buy the settlement security have no property rights in the settlement security until the option is exercised and the security is delivered to the option owner.
- Of a put option to sell the settlement security, if they own the settlement security, retain all property rights in the settlement security until the option is exercised and the security is delivered to the option issuer.

The issuers:

- Of a call option, if they own the settlement security, retain all property rights in the settlement security until the option is exercised and the security is delivered to the option owner.
- Of a put option have no property rights in the settlement security until the option is exercised and the security is delivered to the option issuer.

Some options, after they are exercised, may be settled by a money-difference payment to the option owner and no delivery of a security.

Some debt and equity securities have optionlike features called "embedded options." These securities include convertible bonds, callable and putable bonds, and callable preferred stock. Debt and equity securities with optionlike features are not option securities.

A "warrant" is a call option. Warrants that are detachable from the host debt or equity security, and therefore not embedded, are separate option securities.

A "right" is a call option. Rights that are transferrable, and therefore not embedded, are separate option securities.

SECURITIES TRANSACTIONS

Various sections of the securities law regulate securities by requiring issuers to register securities with the securities-regulation agency and periodically to communicate reports to the securities regulator relating to the issuer's financial condition and operational activities.

Separately, the securities law regulates transactions in securities. If the financial asset to be sold in a primary market or bought and sold in a secondary market is a security, then the transaction itself is regulated for the purpose of protecting investors and achieving other regulatory objectives.

If the issuer of a security has complied completely with the applicable registration and reporting sections of the law, then the issuer is not responsible when the security is bought and sold in fraudulent transactions initiated by others. The fraudulent transaction can be separated from the security.

Some securities are exempt from the registration and reporting sections of the law; however, transactions in these securities are regulated by the fraud-prohibition sections of the law.

[Notes 10–11]

INSTITUTIONAL AND FUNCTIONAL REGULATION

Historically, the securities issued by banks and insurance companies and the financial services they provide were regulated by the banking law and the insurance law. After a separate securities law is established, it is not always clear to what extent or how the securities law should be applied to the activities of banks and insurance companies. The questions created by a separate securities law include:

- If banks and insurance companies issue debt and equity securities for sale in public primary markets, should the sale of these securities be regulated by the banking and insurance laws or by the securities law that regulates securities issued by nonbank and noninsurance entities?
- If banks and insurance companies have issued securities that are or may be bought and sold in public secondary markets, should these issuers comply with the registration and periodic-reporting obligations created by the securities law?
- If banks provide securities-related services to the public, such as the services of a broker or dealer, should these services be regulated by the banking law or by the securities law that regulates nonbank broker-dealers? If the services of banks are regulated by the securities law, should they be supervised by a banking-regulation agency or by the securities-regulation agency?
- If insurance companies provide securities-related services to the public, such as the services of an investment manager, should these services be regulated by the insurance law or by the securities law that regulates investment advisers and investment companies? If the services of insurance companies are regulated by the securities law, should they be supervised by an insurance-regulation agency or by the securities regulator?

The regulation and supervision of banks and insurance companies that issue securities and provide securities-related services can be divided into two categories: institutional regulation and functional regulation.

[Note 12]

Institutional Regulation

In a structure described as "institutional regulation," the securities law does not apply to any entity that is regulated by the banking law or insurance law, even when that entity offers or sells securities in a public market or provides securities-related services to the public. Banks and their activities are regulated by the banking law and supervised by a banking regulator. Insurance companies and their activities are regulated by the insurance law and supervised by an insurance regulator.

Institutional regulation in its purest form exists when banks and insurance companies are excluded from the scope of the securities law.

Institutional regulation emerges at an early stage of economic development. Entities that take deposits and make loans are banks regulated by the banking law. Entities that provide liability, life, and property insurance are insurance companies regulated by the insurance law. That structure is not cost efficient and not effective after a securities law is established to regulate securities, securities markets, and securities transactions. Then, if banks and insurance companies provide securities-related services, there are three regulators of the same activities.

Institutional regulation creates multiple regulators with equal or ambiguous authority over the same activities. Multiple regulators are not effective unless they coordinate their objectives, rule-making processes, compliance standards, and enforcement activities. That is not a realistic expectation because:

- Regulatory objectives may be in conflict. For banking regulators, the first objective is to protect depositors; for insurance regulators, it is to protect the beneficiaries of insurance contracts; and for securities regulators, it is to protect investors. In that context, investors are both investors who own the debt and equity securities issued by banks and insurance companies and investors who use the securities-related services of banks and insurance companies.
- Regulatory capital required for banks, insurance companies, and securities broker-dealers may be different. The risks are different and the methods of calculating the potential losses associated with these risks are different.
- Systemic risks of liquidity and settling transactions may be different.
- Banking and insurance regulators usually do not establish the same standards for disclosures and sales practices as the standards prescribed by the securities regulator. These differences create the conditions for so-called regulatory arbitrage, by which securities-related services become concentrated under the most lenient regulator.

Each regulator may also limit competition and innovation for the purpose of preserving its authority and protecting the industry it regulates.

Separate and not equal regulation of securities, markets, and transactions has been the cause of regulatory failures. For these reasons, the law-making body that approves banking, insurance, and securities laws usually adopts functional regulation.

Functional Regulation

In a structure described as ''functional regulation,'' the securities law applies to any entity, including a bank or an insurance company, that offers or sells its issued securities in a public market or provides securities-related services to the public. Any bank that is a securities broker or dealer is regulated by the securities law that applies to nonbank broker-dealers. Any insurance company that is an investment manager is regulated by the securities law that applies to investment advisers and investment companies.

An important objective of functional regulation is equal regulation of entities that issue securities and equal regulation of entities that provide securities-related services. The popular metaphor ''level playing field'' means equal regulation.

When complete functional regulation is not in the public interest, the law-making body may exempt banks, or insurance companies, or both, from certain sections of the securities law.

An entity regulated by the securities law usually is supervised by the securities-regulation agency; however, the law-making body may authorize one or more banking regulators or insurance regulators to administer the securities law as it applies to banks and insurance companies.

Functional regulation may be applied to activities within banks and insurance companies. More often, banks and insurance companies that provide securities-related services form holding companies. Each holding company owns banking, insurance, and securities subsidiaries. Each subsidiary is regulated by the appropriate banking, insurance, or securities law and supervised by the appropriate banking, or insurance, or securities regulator. The holding company is regulated separately by one of the functional regulators. Thus the consolidated financial condition of a holding company could be examined by the banking regulator while the net capital of that company's broker-dealer subsidiary is examined by the securities regulator.

As an alternative to maintaining separate banking, insurance, and securities regulators and assigning their regulatory responsibilities by functions, the law-making body may merge the three regulators into one entity that operates as a super-regulator for all issuers of securities and all entities that provide financial services. Even after such a merger, however, the super-regulator's activities will be performed separately by functionally specialized departments and divisions. In that situation, productive cooperation among departments and divisions becomes an important regulatory objective.

[Notes 13–15]

International Regulation

In addition to matters that can be described as institutional or functional, another dimension to regulation is the extent to which securities, markets, and transactions in one country may be regulated indirectly by the laws and regulators of other countries.

The securities regulators in some countries have bilateral agreements with regulators in other countries. Each agreement is called a "memorandum of understanding." One country, by the terms of such a memorandum, allows access to its markets by issuers and entities regulated by another country. Further, the regulators agree to share information and to cooperate in the enforcement of each country's laws. The citizens of both countries benefit when these agreements support efficient capital formation and comparable standards for investor protection.

In some of these agreements, however, there is the potential for regulatory arbitrage. If Country 1 and Country 2 have a memorandum of understanding, and in some matters Country 1's regulation is less demanding than Country 2's regulation, then issuers of securities and entities that provide securities-related services may find it advantageous to be regulated in Country 1 as a means of gaining access to the markets of Country 2.

[Note 16]

EXCLUSIONS AND EXEMPTIONS

Regulatory objectives are expressed in the securities law. These objectives are written into the law and administered by the securities-regulation agency based on one of two assumptions:

1. All entities and natural persons that buy securities in primary markets and secondary markets need the same securities-law protection, or

2. Some entities and persons that buy securities do not need the same securities-law protection as the protection appropriate for other buyers with limited financial resources and investment experience.

The first assumption makes all markets public markets and leads to one-size-fits-all regulation. Issuers incur the costs and risks of registering securities and communicating reports periodically to the securities regulator, even when the potential buyers or current owners of these securities are sophisticated investors who understand the risks without standardized disclosures. That form of regulation does not support cost-efficient and effective capital formation.

The second assumption leads to exclusions and exemptions that create private markets. Registration of securities and reporting by issuers is required if securities are sold in public markets; however, securities are exempt from registration and issuers are exempt from reporting when the securities are bought in private markets by entities and persons called accredited investors and by entities called qualified institutional buyers. That form of regulation supports cost-efficient and effective capital formation.

To implement regulation based on the second assumption, some securities-law sections are written in two parts. In the first part, the law uses broad language to define or describe the securities, or markets, or transactions to be regulated. In the second part, the law eliminates certain securities, or markets, or transactions from those defined or described in the first part. The remaining securities, markets, and transactions are regulated.

These eliminations are called exclusions and exemptions:

- The word ‘‘exclude’’ means to omit, or remove, or separate certain entities, persons, securities, and transactions from the scope of the securities law. Exclusions by the lawmaking body limit the scope of the law.

  Exclusions from the securities law are shown in Exhibit 1.2.
- The word ‘‘exempt’’ means to excuse or release certain entities, persons, securities, and transactions from compliance with securities-law obligations that otherwise would

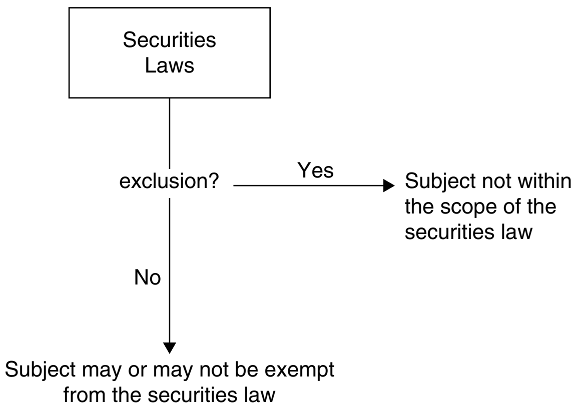

EXHIBIT 1.2 Exclusions from the Securities Laws

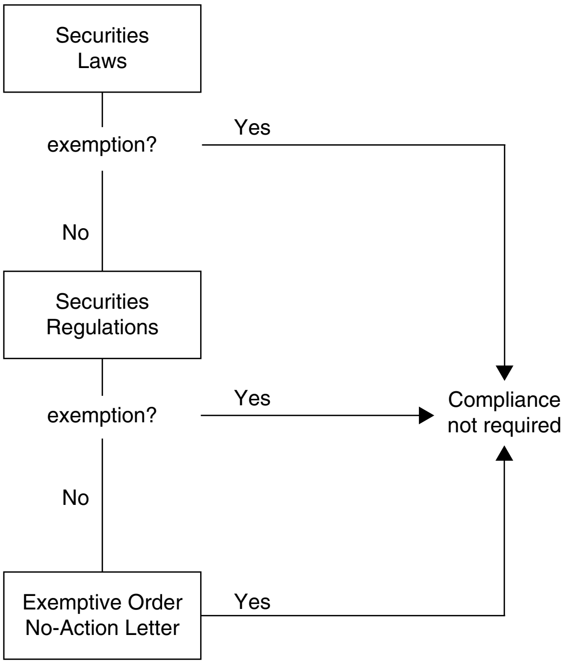

EXHIBIT 1.3 Exemptions from the Securities Law and Regulations

apply. Exemptions by the law-making body and regulators adjust the administration of the law.

Exemptions from the securities law and regulations are shown in Exhibit 1.3.

The authority to exempt is delegated by the law-making body to the securities regulator and other regulators. That has the practical effect of shifting certain matters out of the law-making process and into the regulation-making process. Thus, the law provides a structure, but regulators may use exemptions selectively to avoid the adverse consequences of one-size-fits-all regulation.

The law-making body's intention to create exclusions or exemptions, or to delegate exemptive authority, is expressed in the words of the law. Some laws use "does not include" to mean exclusion. Some laws and regulations use the words "exception" and "excepted" to mean exemption and exempted.

In addition to the exemptions that the securities regulator is authorized to establish in regulations, the regulator may use exemptive orders and no-action letters to accomplish similar results in specific circumstances. Such orders and letters from the regulator respond to requests for guidance or interpretations in matters relating to compliance. The scope of an exemptive order or a no-action letter is narrower than the scope of a regulation.

The rules of self-regulatory organizations may exempt certain activities of their members, if such exemptions are consistent with the purpose of the law and approved by the regulator.

[Notes 17–19]

Securities Exclusions and Exemptions

The authority of the securities-regulation agency is based on the securities-law definition of a "security" and possibly on whether a specific bond, note, or stock is an investment contract. If there is a security and it is an investment contract, then the securities regulator usually has authority to regulate that security. In some situations, however, even when there is a security and an investment contract, the regulator's authority may be limited by securities-law exclusions and exemptions.

Some securities may be excluded completely from the scope of the securities law. It is not relevant whether such a security is or is not an investment contract because the security is not regulated. The distinction between private and public markets is not important.

Some securities within the scope of the securities law may be exempt from certain sections of the law. Exemptions affect the issuers of securities differently depending on the words of the law and regulations. A security that is exempt from registration when sold in a private primary market may or may not be exempt from registration when the same security is bought and sold in a public secondary market. The distinction between private and public markets is important.

Securities may be excluded from the scope of the law or exempted from the registration sections of the law for reasons relating to the characteristics of a security. Registration is not required for debt securities issued or guaranteed by a government entity and is not required for private-sector debt securities with an original-issue maturity of only a few months. In a structure of functional regulation, registration may or may not be required for securities issued by entities regulated by the banking law or by the insurance law.

Securities may also be exempted from the registration sections of the law if they are sold in exempt transactions. Exempt transactions include: primary-market transactions in which the total value of a security issue is less than a certain money amount; primary-market transactions in which the total amount of a security issue is sold to accredited investors; and secondary-market transactions in which securities are sold to qualified institutional buyers.

The securities law delegates authority to the securities-regulation agency to exempt certain issuers of securities from compliance with the registration sections of the law, if an exemption is in the public interest.

Securities exempt from registration are not exempt from sections of the law that prohibit fraudulent transactions.

[Notes 20–21]

Accredited Investors and Qualified Institutional Buyers

Securities not excluded from the scope of the securities law or not exempted from the registration sections of the law must be registered by the issuer with the securities-regulation agency before they are sold. It is possible, however, for a security not otherwise exempted from registration to acquire a one-time exemption each time it is sold to an accredited investor or to a qualified institutional buyer. With respect to these one-time exemptions:

- An issuer may sell a nonregistered security to an accredited investor without activating the securities-law requirement that the issuer register that security with the securities regulator.

- An accredited investor or qualified institutional buyer that owns a nonregistered security may sell that security to a qualified institutional buyer without activating the securities-law requirement that the issuer register that security with the securities regulator.

A not-excluded or not-exempted security must be registered if sold to an entity or a person that is not an accredited investor or not a qualified institutional buyer. In that context:

- An "accredited investor" is an entity or a person that controls a substantial amount of financial resources and, for regulatory purposes, is assumed not to need the standard disclosures that would be required for securities sold in a public primary market, and
- A "qualified institutional buyer" is an entity that controls a substantial amount of financial resources and, for regulatory purposes, is assumed not to need the standard disclosures that would be required for securities sold in a public secondary market.

The securities law and regulations establish the criteria by which entities and persons are categorized as accredited investors or qualified institutional buyers. Further, the securities law delegates authority to the regulator to designate entities and persons, or classes of entities and persons, as accredited investors or qualified institutional buyers.

The sections of the law that prohibit fraud in securities transactions apply to the offer and sale of any security not excluded from the scope of the law, whether sold in a private market or a public market. Thus, the buyers of securities in private markets have the same protection against illegal activities as the protection provided to buyers in public markets.

The buyers of securities may be categorized generally as institutional or retail. Most institutional buyers qualify as accredited investors and qualified institutional buyers, but some do not. Some retail buyers qualify as accredited investors, but most do not.

[Notes 22–24]

Other Exclusions and Exemptions

The securities law regulates securities-related services by defining words such as "broker," "dealer," "exchange," "investment adviser," and "investment company." Entities and persons that perform the functions described by these definitions are required to be registered with the securities-regulation agency. Certain entities and persons may be excluded or exempted from these definitions or exempted from registration:

- The securities law excludes brokers and dealers from the law's definition of an investment adviser and exempts other entities and persons from registration as an investment adviser.
- Securities regulations exempt alternative trading systems from the securities-law definition of an exchange if the entities that operate such systems are registered as broker-dealers.

Brokers and dealers are not required to be registered with the securities regulator if the transactions they execute involve only:

- Financial assets not defined as securities, or
- Financial assets excluded from the scope of the law.

By contrast, brokers and dealers that execute only exempted transactions for securities or transactions only for exempted securities usually are required to be registered with the regulator.

The securities law delegates authority to the regulator to exempt entities and persons from compliance with certain sections of the law, if an exemption is in the public interest.

STRUCTURE OF SECURITIES LAWS

A law-making body formulates securities-regulation objectives and approves securities laws for various purposes relating to both primary markets and secondary markets.

Primary-market transactions are executed in dealer markets and direct-issue markets.

Secondary-market transactions are executed in dealer markets, exchange markets, and through alternative trading systems operated by broker-dealers. Self-regulatory organizations report the prices and quantities of these transactions to the public. Secondary-market transactions also are executed directly between a buyer and sellers by the terms and conditions of a public bid.

Primary-market and secondary-market transactions are settled by deliveries of securities and payments of money through banks and settlement facilities.

After-settlement services are provided:

- To issuers of securities by transfer agents, and
- To owners of securities by broker-dealers, custodians, and settlement-facility depositories.

Given the broad scope and complexity of securities regulation, it is cost efficient and effective to administer a small number of laws instead of one super-law or a large number of single-subject laws. One super-law will be taxonomically dense and therefore difficult to administer. A large number of single-subject laws will be fragmented, or redundant, or both.

A small number of laws can be organized in one of two structures based on either:

- A primary-market law and a secondary-market law, and
- A securities-registration law and a markets-regulation law.

Both of these structures include three single-subject laws: an investment-management law, a securities-account insurance law, and a securities-regulation agency law. The single-subject laws are the same in both structures.

In both of these two structures, there are five securities laws. These laws are amended from time to time by the law-making body. The securities-regulation agency establishes and amends regulations to administer these laws.

[Notes 25–26]

Primary-Market and Secondary-Market Laws

In this structure, shown in Exhibit 1.4, the securities law is comprised of a primary-market law, a secondary-market law, and three single-subject laws. The single-subject laws include an investment-management law, a securities-account insurance law, and a securities-regulation agency law.

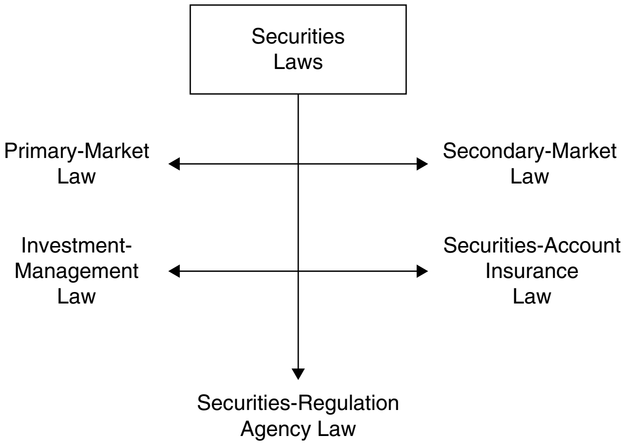

EXHIBIT 1.4 Organization of the Securities Law

Among other things, a primary-market law:

- Requires issuers to register securities with the securities-regulation agency and to communicate certain information, in the form of a prospectus, to potential buyers prior to the sale of securities in a public primary market.
- Delegates authority to the securities regulator for the purpose of regulating:
  - Primary-market transactions;
  - Registered entities and natural persons that provide securities-related services; and
  - Nonregistered entities and persons if their activities are regulated.

Among other things, a secondary-market law:

- Requires issuers of securities that are or may be bought and sold in a public secondary market to register the securities with the securities regulator and to communicate periodic and event-driven reports to the regulator, and
- Delegates authority to the securities regulator for the purpose of regulating:
  - Secondary-market transactions;
  - Registered entities and persons that provide securities-related services; and
  - Nonregistered entities and persons if their activities are regulated.

All equity securities registered for sale in a public primary market, and some equity securities not registered for sale in a public primary market, are required to be registered under the secondary-market law.

Primary-market and secondary-market laws exclude or exempt certain entities and persons, securities, and transactions from the scope of the law or from certain sections of the law and delegate exemptive authority to the regulator. Exclusions in the primary-market law usually are carried over to the secondary-market law. Exemptions in the primary-market law may or may not be carried over to the secondary-market law.

[Notes 27–28]

Securities-Registration and Markets-Regulation Laws

In this structure, the securities law is comprised of a registration law for all securities, a regulation law for all markets, and three single-subject laws: an investment-management law, a securities-account insurance law, and a securities-regulation agency law.

Among other things, a securities-registration law:

- Requires issuers to register securities with the securities-regulation agency and to communicate certain information, in the form of a prospectus, to potential buyers prior to the sale of the securities in a public primary market, and
- Requires issuers of securities that are or may be bought and sold in a public secondary market to register the securities with the securities regulator and to communicate periodic and event-driven reports to the regulator.
- Does not apply to the regulation of markets.

Among other things, a markets-regulation law:

- Delegates authority to the securities regulator for the purpose of regulating:
  - Primary-market and secondary-market transactions;
  - Registered entities and natural persons that provide securities-related services; and
  - Nonregistered entities and persons if their activities are regulated.
- Does not apply to the registration of securities or reporting by issuers.

Securities-registration and markets-regulation laws exclude or exempt certain entities and persons, securities, and transactions from the scope of the law or from regulation and delegate exemptive authority to the regulator.

OTHER SECURITIES LAWS

The major securities laws, whether organized by primary and secondary markets or organized by registration and regulation, are supplemented by a small number of single-subject laws. That structure makes it possible to control the scope and simplify the administration of each law. There are three single-subject laws: an investment-management law, a securities-account insurance law, and a securities-regulation agency law.

Investment-Management Law

An investment-management law regulates:

- The activities of investment companies that issue and sell equity securities to the public for the purpose of acquiring money that the investment company will invest in securities issued by other companies, and
- The activities of investment advisers that receive compensation for investment-advisory and investment-management services. These services include investment advice and transaction recommendations, managing investments as an agent for investors, and continuously managing the assets of investment companies.

The investment-management law may exclude or exempt certain entities and natural persons, securities, and transactions from the scope of the law or from certain sections of the law, and it may delegate exemptive authority to the securities-regulation agency.

[Notes 29–30]

Securities-Account Insurance Law

The cost efficiency of capital formation depends in part on public perception that customer-owned assets are safe when held by broker-dealers registered with the securities-regulation agency. Public confidence in broker-dealers is essential when securities are dematerialized or security certificates are immobilized. In these circumstances, broker-dealers usually hold customer-owned securities as book entries in their nominee name.

A securities-account insurance law protects the customers of broker-dealers against the loss of customer-owned money and securities controlled by a broker-dealer if that broker-dealer becomes insolvent. It must be understood, however, that the law does not protect:

- Customers against losses in the market value of customer-owned securities;
- Customers when the issuers of customer-owned debt securities default on their payment obligations; and
- Any one customer for a money amount or the value of securities more than the limit stated in the law.

For purposes of administering securities-account insurance, the law:

- Designates a private-sector entity as a special-purpose self-regulatory organization (SRO).
- Authorizes that SRO to administer the law.
- Requires most broker-dealers to be members of the SRO.

If a broker-dealer member of the securities-account insurance SRO becomes insolvent, then a trustee takes control of that broker-dealer's assets. Customer-owned money is paid and customer-owned securities are delivered from the insolvent member to accounts for the same customers with other broker-dealers. If the insolvent member does not hold sufficient assets for that purpose, then the SRO uses money from other sources to make payments and to buy the securities required for deliveries.

The law requires all members to contribute member-owned assets to a permanent insurance fund administered by the SRO. The assets of an insolvent member plus the total assets of the fund are available to satisfy customers' claims against that member. If the insolvent member's assets and the assets of the fund are not sufficient to satisfy the claims of all customers, then the SRO may require solvent members to make additional contributions to the fund.

A securities-account insurance SRO is not regulated as an insurance company and does not maintain capital and reserves according to insurance-industry standards, because the SRO does not rely on its capital and reserves to satisfy claims. Instead, losses caused by insolvent members are distributed among the solvent members.

The SRO is a guarantor, not an insurer. The guarantee is secured by the securities-law authority for both the:

- SRO to collect contributions to the insurance fund from members, and
- Government, if necessary, to lend money to the SRO for the purpose of satisfying customers' claims against insolvent members.

A securities-account insurance law may:

- Exclude certain entities and natural persons, securities, and transactions from the scope of the law;
- Exempt certain entities and persons from compliance with sections of the law;
- Limit the amount of claims for customer-owned money and securities held by an insolvent broker-dealer; and
- Delegate exemptive authority to the SRO, to the securities regulator, or both.

The securities-account insurance law should be integrated with the bankruptcy law to ensure that the termination of an insolvent broker-dealer's business and the distribution of its assets are administered in a manner that is consistent with the regulatory objects of investor protection, fair and orderly markets, and control of systemic risk.

Broker-dealer members of the SRO may buy supplemental securities-account insurance from private-sector insurance companies. Such insurance pays money or delivers securities to the customers of an insolvent broker-dealer for losses in excess of the limit established by the securities-account insurance law.

[Notes 31–37]

Securities-Regulation Agency Law

A securities-regulation agency law establishes a government agency as the securities regulator. That law specifies the number, qualifications, terms of office, and other matters relating to the nomination and appointment of natural persons authorized to govern the agency.

The management of the agency is a function separate from the agency's administration of the securities law. The securities-regulation agency law assigns responsibility and delegates authority for planning, organizing, directing, and controlling the agency's staff and resources according to such policies and procedures as the agency may adopt from time to time.

The law also makes explicit how the agency will receive money for the purpose of paying its expenses; that is, whether the agency's expenses are paid from the government's general income or paid from fees and monetary penalties collected by the agency. Usually all of the agency's expenses are paid from general income. Then all fees and some penalties collected by the agency are transferred to general income. By that arrangement, the agency has a reliable source of money and is not dependent on fluctuating amounts of fees and penalties to pay its expenses.

[Notes 38–40]

REGULATORY OBJECTIVES

A law-making body formulates securities-regulation objectives. These objectives are stated in the securities law to guide government agencies and departments in their administration of the law and to assist courts in their interpretation of the law.

There are four generally accepted objectives of securities regulation:

1. Investor protection
2. Fair and orderly markets
3. Control of systemic risk
4. Competition

[Notes 41–42]

Investor Protection

''Investor protection'' means the protection of investors against financial losses as a result of fraud and other illegal activities. That includes the enforcement of obligations relating to:

- The activities of directors and managers of publicly owned companies;
- The activities of attorneys and accountants who advise public companies;
- The best execution of transactions for investors; and
- The suitability of securities recommended as investments.

''Investor protection'' also means the protection of:

- Customer-owned assets controlled by broker-dealers and investment advisers;
- Investment-company assets; and
- Money and securities for which settlement facilities are responsible.

Securities-account insurance protects a limited amount of customer-owned assets held by broker-dealers if a broker-dealer becomes insolvent.

''Investor protection'' does not mean protection against a loss in the market value of a security or a loss resulting from a security issuer's default on a payment obligation. The securities law does not protect investors against the inherent risks of investments.

[Notes 43–50]

Fair and Orderly Markets

The regulatory objective that markets be operated in a fair and orderly manner applies to both primary and secondary markets, including dealer markets, direct-issue markets, and transaction-execution facilities such as alternative trading systems or exchanges.

The securities-regulation agency establishes regulations to ensure that:

- The issuers of publicly owned securities provide accurate, complete, and timely disclosures relating to securities bought and sold in public markets, and
- Public secondary markets provide transparency to the public in the form of current bid-offer quotations and last-transaction prices for securities.

Broker-dealer associations and exchanges, both self-regulatory organizations, also establish and enforce rules to ensure the orderly execution of transactions at fair prices.

It is important that transactions executed in primary and secondary markets be settled by deliveries of securities and payments of money on the contractual settlement date and, if appropriate, that the ownership of such securities be changed promptly.

[Note 51]

Control of Systemic Risk

The words ''systemic risk'' are used most often in the securities industry to mean transaction-settlement risk. In that context, systemic risk is the risk that one settlement failure will cause other failures. It is the risk:

> that one entity's failure to deliver a security or to pay money on the contractual settlement date will cause that entity's counterparties to fail in the settlement of their obligations to another set of counterparties on the same day, and so on to a third or fourth set of counterparties.

One large settlement failure or a number of failures on the same day may cause banks to suspend payments and cause securities markets to suspend trading.

The regulatory objective of controlling transaction-settlement risk:

- Begins with the capital of broker-dealers;
- Continues to the risk-management policies and procedures of settlement facilities; and
- Requires cooperation between the banking-regulation agency that regulates interbank payments and the securities-regulation agency that regulates markets and settlements.

[Note 52]

The words ''systemic risk'' also mean the liquidity risk associated with owning long-term securities financed by money borrowed for a short period (usually one to seven days). The reason for owning such securities is the potential profit from the difference between the interest received from the securities (such as 6%) and the interest paid for borrowings (such as 2%). That is not arbitrage because the maturity dates of the asset and the liability are not the same.

The borrowers of short-term money deliver the long-term securities as collateral to the lenders. The amount of money borrowed must be reborrowed continuously for short periods until the securities are sold and financing is no longer needed. The risk to the borrower of money is that the market value of the securities may decline. If that happens, then the lender will demand additional securities to collateralize the same amount of money lent. A highly leveraged borrower will have no equity in securities that can be delivered as additional collateral. The borrower will default on its obligations to the lender. That is a systemic problem because the borrower's default may cause subsequent defaults if lenders and transaction counterparties suspend or reduce significantly the credit lines or trading limits previously available to the defaulting party.

Bank capital is reduced by losses on bank loans to the owners of securities. Such losses reduce the lending capacity of banks and may cause banks to reduce lending to finance securities. That may cause large amounts of securities that cannot be financed to be offered for sale and further decrease the market value of securities.

The financing form of systemic risk led to enormous losses, and some bankruptcies, during the period from mid-year 2007 through year-end 2008 when the mark-to-market value of mortgages and mortgage-backed securities decreased significantly.

[Notes 53–55]

Competition

Competition, the fourth regulatory objective, is essential to the cost efficiency and effectiveness of capital formation. Competition:

- Increases the diversity of borrowing sources and investment opportunities;
- Increases the quality and decreases the cost of securities-related services; and
- Allows issuers of securities and investors to make choices based on costs and risks.

In that context, the securities law:

- Supports the equal regulation of entities that issue securities;
- Supports the equal regulation, also called functional regulation, of entities that provide securities-related services;
- Requires the securities-regulation agency to consider the competitive consequences of its regulatory decisions; and
- Prohibits self-regulatory organizations from fixing commissions and other fees that members charge their customers.

The competition law, separately, prohibits contracts, or combinations, or conspiracies for the purpose of monopolizing commerce.

[Notes 56–57]

DISCLOSURE AND TRANSPARENCY

The words ‘‘disclosure’’ and ‘‘transparency’’ are used ambiguously to mean something inherently good and therefore desirable as an element of regulation. Often these words are used interchangeably; however, they are most useful when given specific meanings.

Disclosure of Information

The information disclosed by the issuer of a security is relevant to investors’ decisions to buy, hold, or sell that security. These disclosures also are relevant to a stock owner’s decision to vote for (or against) the election of persons to be directors of the issuer, the sale of the issuer's assets, and other matters that require stock owner approval.

The information disclosed by registered entities, such as broker-dealers and settlement facilities, is relevant to the securities-regulation agency's supervision of such entities.

The information disclosed by nonregistered entities and persons, including some beneficial owners of securities, is relevant to the securities regulator's enforcement of the securities law.

Accordingly, the securities law authorizes the regulator to establish regulations that require disclosures of information by the:

- Issuers of registered securities;
- Entities and natural persons registered with the regulator; and
- Entities and persons not registered with the regulator if their activities are regulated.

As a generalization, the word "disclose" means to allow or to cause something to be made known to others, while a "disclosure" is that which is made known. Beyond that generalization, the law and regulations set high standards to ensure that disclosed information is accurate, complete, and timely. In addition to allowing or causing something to be known, an entity or a person with a disclosure obligation must:

- Not make any statement that is false or misleading with respect to any material fact, and
- Not omit any material fact if that omission makes any statement false or misleading.

Securities regulations also suggest that disclosures be written in plain language. Disclosures in nineteenth-century legalese with 60-word sentences and double negatives provide little or no useful information.

The regulator requires disclosures for a number of practical reasons, such as to:

- Obtain information needed by the regulator and by self-regulatory organizations to monitor compliance with the law, regulations, and rules;
- Inform the owners of securities how persons are nominated and elected to the issuing company's board of directors;
- Inform the owners of securities about the issuing company's financial performance as measured by generally accepted accounting principles;
- Inform the owners of securities about related-party transactions; and
- Inform the owners of investment companies how much they are being charged in commissions and fees for transactions and services.

Entities and persons with disclosure obligations may be exposed to civil or criminal penalties if they fail to disclose accurate, complete, and timely information as required by the securities law and relevant regulations.

The securities law should allow the regulator to delay or limit public access to disclosures if such disclosures contain confidential information. Otherwise, privately owned companies, which have no disclosure obligations, would have the competitive advantage of immediate access to the disclosures of their publicly owned competitors.

Disclosures cost money. These costs are created by laws and regulations and ultimately are paid by the owners of securities. Such costs reduce the effectiveness of capital formation. The high cost of doing business in some countries has driven securities markets to other countries with lower costs.

[Notes 58–60]

Transparency of Markets

The securities law states that fair and orderly markets are a regulatory objective. In that context, it is in the public interest for markets to:

- Provide efficient means for the execution of secondary-market transactions;
- Communicate to the public the prices at which securities have been bought and sold;
- Communicate to the public the highest current bid prices and the lowest current offer prices (quotations) at which securities may be sold and bought; and
- Provide opportunities for transactions to be executed at the best bid and offer prices then available in two or more markets that comprise a national market system.

The word ''transparent'' describes the condition or state of a public market in which currently available prices and quantities of securities are communicated promptly to prospective buyers and sellers. There is no single standard for good transparency. Periodic auction markets, also known as call markets, provide the public with no information relating to bids and offers prior to the time orders are matched. Some exchange markets are driven by public orders to buy or sell equity securities at a maximum or minimum price. By contrast, markets for debt securities are driven by the quotations of competing dealers or by the actions of dealers that buy or sell at other dealers' offers or bids.

The concept of transparency applies to markets for both debt and equity securities. In practice, however, securities regulators always put a higher priority on regulating and supervising equity-securities transactions executed on exchanges. A large proportion of exchange orders come from persons not well informed about the mechanics of order execution. By contrast, most debt-securities transactions are executed in dealer markets between professional traders employed by dealers and institutional investors.

The immediate communication of transaction information to the public usually supports the regulatory objective of fair and orderly markets. However, in quote-driven exchange markets and dealer markets, immediate price and quantity reporting may create significant risks for market makers and dealers that execute large transactions. It takes time for these buyers to hedge or sell a large quantity of a security. If the price and quantity of a large transaction are known immediately in the market, then the market knows that a large amount of the security probably is for sale. That is not good for the market maker or dealer that bought the security. For that reason, market rules may allow some delay, such as one or two minutes, in communicating to the public the details of large transactions.

Transparency costs money, but there are clear and immediate benefits. Transparency is a competitive advantage for dealers, exchanges, and inter-dealer brokers that provide prompt and reliable prices to prospective buyers and sellers. The cost of transparency has been decreased significantly over the past 20 or 30 years because of the ever-increasing capacity and power of communications and information-processing systems.

[Note 61]

REGULATION AND SUPERVISION

A law-making body formulates securities-regulation objectives and approves securities laws. These laws delegate to the securities-regulation agency and other regulators the authority to regulate and supervise entities and natural persons required to comply with the law.

The securities law delegates the authority to establish regulations; however, the law does not specify the elements of a regulation-making process. If such elements were explicit, they would include:

- A clearly stated purpose for regulatory activities.
- Empirical evidence to guide regulatory decision making.
- Regulatory language that provides market participants with legal certainty.
- Regulatory benefits that exceed costs.
- Consideration of the possibilities for unintended consequences.

The securities law is administered in parallel with and to complement nonsecurities laws. Securities-law regulation and supervision should not duplicate other laws and not leave gaps between the securities law and other laws.

[Note 62]

Regulation

In one sense, the word ‘‘regulation’’ means a rule or collection of rules published as an official document by the securities-regulation agency. These rules state what is required or prohibited in order to comply with the law. The words ‘‘regulation’’ and ‘‘rule’’ are used interchangeably. Regulations are codified as amended in the government’s regulations, which are available to the public in printed form and from government and private-sector Web sites.

In another sense, the word ‘‘regulation’’ means controlling and directing activities according to laws, policies, and principles. Securities regulation is based on laws that:

- State regulatory objectives;
- Define the word ‘‘security’’;
- Establish standards for the execution and settlement of transactions in primary markets and secondary markets; and
- Delegate administrative authority.

These laws are codified as amended in the government’s general and permanent laws, which are available to the public in printed form and from government and private-sector Web sites.

The scope of activities regulated by the securities law includes:

- Entities that issue securities if the securities are registered or required to be registered with the securities regulator;
- Entities that are registered with the regulator as self-regulatory organizations (SROs);
- Entities authorized by the law to be special-purpose SROs;

- Entities and natural persons that provide securities-related services and are registered or required to be registered with the regulator or an SRO; and
- Nonregistered entities and persons if their securities-related activities are regulated.

The scope of securities regulation is shown in Exhibit 1.5.

Generally, the securities law prohibits:

- Fraud, manipulation of securities' prices, and violations of fiduciary obligations;
- Trading in publicly owned securities while in possession of material nonpublic information relating to the issuers of such securities;
- Broker-dealers from buying and selling securities as agents or principals when they are not in compliance with regulatory-capital requirements; and
- Other activities that are not compatible with standards relating to investor protection, fair and orderly markets, control of systemic risk, and competition.

The law-making body approves laws, monitors the regulator's administration of laws, and communicates guidance to the regulator. The law-making body also ensures that the regulator has sufficient resources to administer the laws effectively. The process by which the law-making body monitors and guides the activities of the regulator usually is described by the popularized word "oversight."

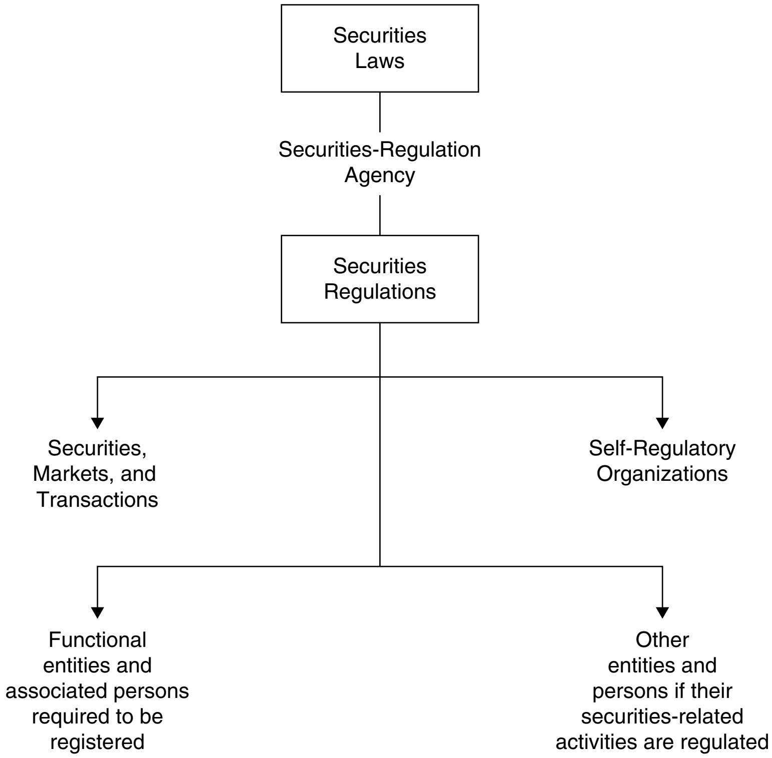

EXHIBIT 1.5 Scope of Securities-Law Regulation

The regulator establishes and amends its regulations:

- As required by new or amended laws and guidance from the law-making body;
- On its own initiative; and
- In response to comments and recommendations from other government agencies, advisory committees, registered and special-purpose SROs, registered entities, industry and professional associations, the issuers of securities, and investors.

New and amended regulations usually are not enforceable unless published and available to the public. The process by which the regulator establishes and amends regulations usually is described by the popularized word ''oversight.''

Registered and special-purpose SROs establish and amend their rules:

- As required by new or amended laws;
- As required by new or amended regulations and guidance from the regulator;
- On their own initiative; and
- In response to comments and recommendations from other SROs, members, industry and professional associations, the issuers of securities, and investors.

New and amended SRO rules usually are not enforceable until approved by the regulator. The rules of an SRO apply to its members. The process by which SROs establish and amend these rules is described by the popularized word ''oversight.''

In standard dictionaries, the word ''oversight'' has two meanings: (1) an error or failure, or omission; and (2) supervision.

Regulations and rules are established and amended by prescribed procedures to ensure that the results provide meaningful benefits to the public at reasonable costs.

[Notes 63–64]

Supervision

The word ''supervision'' means the act of monitoring and from time to time examining activities to ensure compliance with the law, regulations, and rules. The word ''monitor'' means to observe activities systematically. The result of monitoring may or may not lead to an examination. The word ''examination'' means an audit, or inspection, or investigation of activities; however, an examination does not mean an audit by an independent public accountant to verify financial statements. Persons who perform examinations usually are called examiners, not auditors.

The securities-regulation agency supervises:

- The regulated activities of entities that issue securities;
- Registered and special-purpose self-regulatory organizations (SROs);
- Registered entities; and
- The regulated activities of other entities and persons.

Supervision often is described by the popularized word ''oversight.''

The word ''supervision'' is used in the banking industry to mean both regulation and supervision. Thus a banking-regulation agency usually is called a banking supervisor.

There are two categories of examinations:

1. Off-site examinations in which the staff of the securities regulator reviews standard reports and other information received by the regulator from the issuers of registered securities, from registered entities, and from nonregistered entities if their securities-related activities are regulated. These reviews take place in the regulator's office. Most examinations are off-site.
2. On-site examinations in which the staff of the securities regulator enters the premises of an entity involved in securities-related activities to inspect electronic and physical records and to interview persons employed there. On-site examinations of registered entities are scheduled from time to time to confirm compliance with regulations and to verify reports and information received by the regulator. The regulator may initiate on-site examinations without notice if the regulator has cause to believe that any entity or person has violated, is violating, or is about to violate the law.

Effective supervision is not a leisurely process that allows violations of the law to continue for months or years before actions are taken to protect the public. Supervision requires appropriate and timely actions to prevent or detect and stop violations of the law. In that context, the securities regulator must have access to, or the authority to subpoena, the business records and employees of any entity regulated by the securities law. (A subpoena is an administrative or court order that requires the presence of a person or the communication of documents in an examination or judicial proceeding.)

SROs use off-site and on-site examinations to supervise the activities of their members according to rules initiated by each SRO and approved by the securities regulator. That process often is described by the popularized word ''oversight.''

Effective supervision requires a commitment of resources and a systematic approach to monitoring and examining activities in securities markets. In addition, examinations should be used to identify and eliminate conflicting, obsolete, and redundant regulations.

[Notes 65–69]

Control

The scope of regulation and supervision authorized by the securities law is determined in part by the concept of control. That concept is applied by regulations that define control over:

- Entities that issue securities if the securities are registered or required to be registered with the securities-regulation agency;
- Entities such as broker-dealers and exchanges that are required to be registered with the securities regulator; and
- Entities and natural persons not required to be registered with the securities regulator but that are required to comply with the securities law.

The word "control" means the ability of one entity or person to direct the activities of another entity. Control may be derived from:

- The ownership of voting securities;
- An office to which a person is appointed or elected;
- The terms of an agreement; or
- Otherwise.

In that context:

- A parent entity controls another entity directly or indirectly through one or more intermediaries;
- A subsidiary is any entity controlled by the parent directly or indirectly through one or more intermediaries; and
- An affiliate is any entity that controls, is controlled by, or is under common control with another entity.

The concept of control is connected with the beneficial ownership of securities, disclosure obligations, insider trading, related-party transactions, and consolidated supervision.

[Notes 70–71]

Consolidated Supervision

Increasingly in the past 10 to 15 years, large financial organizations have been created in which separate but affiliated entities provide banking, insurance, and securities services. Each entity is supervised by a functional regulator. Thus each entity's regulator is familiar with the operating standards, risk controls, and capital requirements that are appropriate for that entity. At some level within the organization, however, the risks and capital of the affiliates must be consolidated and managed. That level usually is a holding company.

The functional supervision of banking, insurance, and securities subsidiaries must be compatible with supervision of the holding company. Duplications, gaps, and inconsistencies in supervision will lead to costs and risks that do not serve the public interest.

[Note 72]

Penalties for Securities-Law Violations

The securities law authorizes government agencies and departments to impose civil and criminal penalties on entities and natural persons convicted of violating the law. The purpose of such penalties is to deter illegal activities and to provide incentives for publicly owned companies and regulated entities to maintain effective compliance programs.

Historically, securities-law penalties were not a source of money to compensate investors for losses incurred as a result of illegal activities by others. More recently, the law has allowed some money penalties to be used for restitution payments to the victims of illegal activities.

The words "penalty" and "sanction" are used interchangeably in the securities industry. In standard dictionaries, however, the word "sanction" has two meanings: (1) an approval, or encouragement, or permission; and (2) a penalty for illegal behavior or an action to stop such behavior.

[Notes 73–75]

REGISTRATION

The securities law regulates entities, natural persons, and securities that are registered or required to be registered with the securities-regulation agency.

- Securities, if not excluded or exempted, are required to be registered.
- Entities that provide securities-related services, such as broker-dealers and exchanges, if not excluded or exempted, are required to be registered.
- Some persons associated with broker-dealers are required to be registered with the securities regulator or a self-regulatory organization.

The scope of securities-law registration is shown in Exhibit 1.6.

When one entity provides securities-related services and issues securities, that entity must be registered to provide services and separately register its issued securities. The registration obligations of a services-providing entity are different from the obligations of an issuer to register its securities.

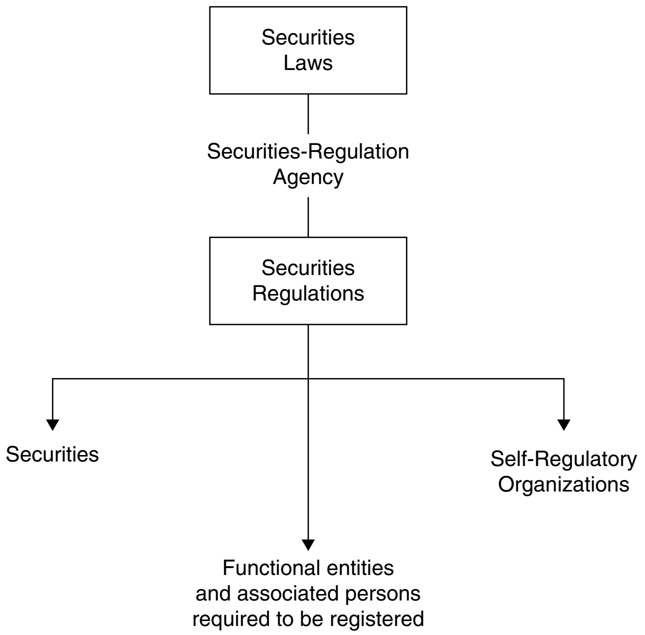

EXHIBIT 1.6 Scope of Securities-Law Registration

The securities law may exclude entities, persons, and securities from the scope of the law, or exempt entities, persons, and securities from the registration sections of the law. The law authorizes the securities regulator to:

- Exempt entities, persons, and securities from registration;
- Approve or deny applications for registration; and
- Limit, or suspend, or revoke previously approved registrations.

REGISTRATION OF SECURITIES

The securities law does not regulate the issuance of securities by companies, corporations, and partnerships.

The securities law identifies securities that, after their issuance, must be registered by the issuer with the securities-regulation agency. That includes securities that are intended to be sold in a public primary market and securities that are or may be bought and sold in a public secondary market. The law prohibits public-market transactions in securities that are required to be registered, but are not registered.

When required by the law, the issuer must register securities that:

- Will be offered and sold in a public primary market. Registration is a one-time event, based on the communication of prescribed information to the securities regulator. That allows a security to be sold in a distribution to investors.
- Are or may be bought and sold in a public secondary market. Registration is a continuing process that includes periodic and event-driven communications of prescribed information to the securities regulator. The registration of an equity security continues for an indefinite period, but the registration of a debt security terminates on the security's maturity date.

The regulator has the authority to deny an issuer's application for the registration of a security and the authority to suspend or revoke an existing registration. Registration applies to a specific issue and amount of a security. If an issuer intends to sell an amount of a security that is fungible with an existing registered issue, then the additional amount must be registered. A registration is not transferable and is not a license that may be bought and sold.

The registration of a security by the issuer with the regulator for secondary-market transactions is different from the listing of a security by the issuer with an exchange. Registration may be required by the law, but listing is not required. As a generalization, all securities listed with an exchange are registered with the regulator, but all securities registered with the regulator are not listed with an exchange.

A security listed with an exchange for secondary-market transactions may be bought and sold:

- On one or more exchange markets according to the rules of each exchange;
- In a dealer market on the terms and conditions agreed by the principals; and
- By the terms and conditions of a public bid.

An issuer also records the names of the owners of a security in the issuer's registry of security owners. A registry is a record of:

- The names of current owners of a security. The record is revised from time to time by adding or deleting the names of owners as a result of a conversion or an exchange of securities, the maturity of debt securities, and transaction settlements.
- The amount of a security owned by each current owner. The record is revised from time to time by increasing or decreasing the amount of a security owned by each current owner as a result of corporate actions and transaction settlements.

The rights to vote an equity security and to receive the benefits of corporate actions are based on the names of current owners recorded in the issuer's registry.

The rights to receive periodic interest payments, if any, and the maturity-value amount of a debt security are based on the names of current owners recorded in the issuer's registry.

Some issuers use an internal department to maintain their registries. Most issuers buy the services of a transfer agent for that purpose. A government agency does not maintain registries for the securities issued by private-sector entities.

[Note 76]

Securities Registration and Reporting by Issuers

Securities not excluded from the scope of the securities law and not exempt from the registration sections of the law must be registered by the issuer with the securities-regulation agency.

Two categories of securities are registered with the securities regulator:

1. Securities that are intended to be sold in a public primary market
2. Securities that are or may be bought and sold in a public secondary market

Most issuers simultaneously register securities for sale in a primary market and for transactions in a secondary market. It is possible, however, that an issuer not required to register securities for sale in a primary market will be required later to register the same securities for transactions in a secondary market.

To register securities for either primary- or secondary-market transactions, an issuer must disclose information relating to the issuer as an entity and information relating to the securities as investments. These disclosures are communicated to the securities regulator. The purpose of such disclosures is to describe the risks of owning the securities. With that information, investors are responsible for making buy, hold, or sell decisions according to each investor's financial circumstances and investment objectives.

The disclosure of accurate, complete, and timely information by the issuers of securities is fundamental to the regulatory objectives of investor protection and the maintenance of fair and orderly markets.

Public Primary Markets

Securities that are intended to be sold in a public primary market, if not excluded or exempted, must be registered by the issuers with the securities-regulation agency.

Registration requires each issuer to disclose all information that is material and relevant to the issuer's financial condition and operations and to the security described in the application for registration.

An issuer usually intends that the total amount of a security registered for sale in a primary market will be sold immediately or within a short period after the effectiveness of the registration. As an alternative, an issuer may apply for the registration of a security that will be sold continuously over a long period or sold in one transaction at some time in the future when market conditions are favorable. These delayed offerings are called "shelf registrations," meaning that the registered securities are "on the shelf" and available for sale by the issuer at any time.

Delayed offerings in the primary market are not the same as delayed settlements in the secondary market. Securities that are registered for a delayed offering and then sold are delivered according to the industry standard for regular settlement; that is, within a few business days after the transaction is executed.

The securities regulator reviews the disclosures made in an application for registration to ensure that the information is accurate, complete, and timely; however, the regulator does not verify all of this information, does not make any judgment as to the investment merits of the security, and does not decide the offering price of the security. The regulator's acceptance of a security for registration does not mean that the regulator approves the security as a suitable investment for any potential buyer.

After the registration is effective and disclosures have been communicated to potential buyers in the form of a prospectus, the security may be sold in a public primary market.

The entities that register equity securities for distribution in a public primary market are called publicly owned companies.

Information communicated by the issuer to the regulator in connection with a registration is available to the public from the regulator's Web site.

[Notes 77–78]

Public Secondary Markets

Securities excluded from the scope of the securities law are excluded from secondary-market registration and reporting. The issuers are not required to register such securities with the securities-regulation agency.

Securities exempt from primary-market registration are usually exempt from secondary-market registration and reporting. It is possible, however, for an issuer to be exempt from registering a security for sale in a primary market but later be required to:

- Register that security with the securities regulator for secondary-market transactions, and
- Communicate periodic and event-driven reports to the regulator.

Securities that are or may be bought and sold in a public secondary market, if not excluded or exempted, must be registered by the issuers with the regulator. Registration requires each issuer to disclose all information that is material and relevant to the issuer's financial condition and operations and to the security described in the application for registration.

The securities regulator reviews the disclosures made in an application for registration to ensure that the information is accurate, complete, and timely; however, the regulator does not verify all of this information and does not make any judgment as to the investment merits of the security. The regulator's acceptance of a security for registration does not mean that the regulator approves the security as a suitable investment for any current owner or potential buyer.

After a security is registered, the issuer must communicate annual, quarterly, and event-driven reports to the regulator. These reports must disclose changes in the issuer's financial condition and operations and changes affecting the registered security. Periodic and event-driven reports are required for as long as the security is regulated by the reporting sections of the law.

Information communicated by the issuer to the regulator in connection with a registration and subsequent reports is available to the public from the regulator's Web site.

As shown in Exhibit 1.7, two categories of equity securities are required to be registered for secondary-market transactions:

1. A security that will be listed with an exchange; or, if not listed,
2. A security that is both issued by an entity with a substantial amount of assets and owned by a large number of security owners

The entities that register equity securities for transactions in public secondary markets are called publicly owned companies.

[Notes 79–84]

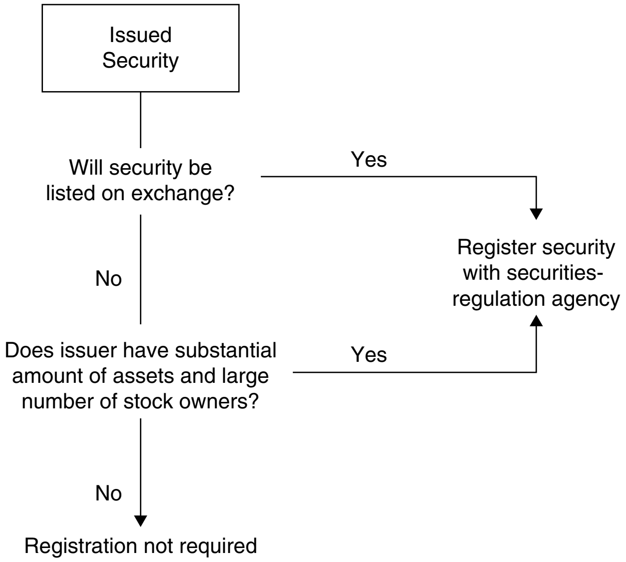

EXHIBIT 1.7 Registration of Equity Securities

Government Securities

Government securities are transferrable debt securities with original-issue maturities ranging from a few weeks to 30 years or more. The money received by the government from the sale of these securities is used for two purposes:

1. To pay current expenses (including interest) that exceed current income from taxes, fees, and other sources.
2. To pay the maturity-value amount of previously issued securities when these payments become due.

As a generalization, there are three categories of government securities:

1. Treasury securities issued or guaranteed by a department of the national government. The maturity-value amount of securities that may be created and sold by that department is approved from time to time by the national law-making body in a public-debt law.
2. Agency securities issued or guaranteed by national-government agencies. The maturity-value amount of securities that may be created and sold by an agency is approved from time to time by the national law-making body.
3. Municipal securities issued or guaranteed by political subdivisions, such as states, counties, cities, and other entities. The maturity-value amount of securities that may be created and sold by a political subdivision is approved from time to time by an appropriate law-making body or other authority.

The securities law usually exempts all three categories of government securities, plus securities issued by foreign governments and international agencies, from certain sections of the law. The issuers of exempt securities are not required to:

- Register securities with the securities-regulation agency before or after the securities are sold in a public primary market;
- Comply with governance, internal-control, and other standards that apply to private-sector issuers of securities; and
- Communicate periodic or event-driven reports to the securities regulator.

These exemptions apply to the issuers of government securities but not to the private-sector entities that execute government-securities transactions. Bank and nonbank brokers and dealers that execute these transactions are regulated by the securities law.

[Notes 85–89]

REGISTRATION OF ENTITIES AND PERSONS

In a structure of laws based on functional regulation, the securities law requires most entities that provide securities-related services to be registered with the securities-regulation agency. Entities are registered by the categories of services they are authorized to provide. An entity registered as a broker-dealer provides the services of a broker, or dealer, or both, but not the services of an investment company. An entity registered as a settlement facility provides transaction-settlement services but not the transaction-execution services of an exchange.

Registration is specific to an entity and has no termination date. Registration is not transferable and is not a license that may be bought and sold.

Among other things, the securities law requires:

- Each broker-dealer association, exchange, and settlement facility to be registered with the securities regulator and to perform the functions of a self-regulatory organization (SRO), and
- Most broker-dealers to be registered with the regulator and to be a member, or to comply with the rules, of one or more registered or special-purpose SROs.

The securities law requires some natural persons associated with a broker-dealer to be registered with an SRO. Registration is specific to a person and has no termination date. Registration is not transferable and is not a license that may be bought and sold.

Further, the securities law requires:

- Some transfer agents to be registered with the securities regulator, unless the transfer agent's compliance with the securities law is supervised by a banking regulator. The law does not require transfer agents to be a member, or to comply with the rules, of an SRO.
- Other entities, such as securities-information processors, investment advisers, and investment companies, to be registered with the securities regulator. The law does not require them to be a member, or to comply with the rules, of an SRO.

The securities law does not require:

- Credit-rating companies to be registered with the securities regulator; however, the law allows such companies to apply for registration with the regulator as a nationally recognized statistical-rating organization (NRSRO). NRSROs are not required to be a member, or to comply with the rules, of an SRO.
- Public-accounting entities to be registered with the securities regulator; however, the law requires such entities, if they audit the financial statements of publicly owned companies, to be a member of a special-purpose SRO.
- The registration of special-purpose SROs.

With respect to entities that are registered in any capacity with the securities regulator, the regulator may suspend or revoke the registration of such entities, or limit their activities, or prohibit them from employing certain persons.

[Note 90]

ISSUERS OF SECURITIES

All private-sector entities that issue debt and equity securities have obligations to the owners of these securities, whether the securities are registered or required to be registered with the securities-regulation agency or not. These obligations are derived from common-law principles and nonsecurities laws. Nonsecurities laws include the commercial law and the company, corporation, and partnership laws that authorize the creation of securities.

Issuers that are not required by the securities law to register their equity securities with the securities regulator are called closely held, or privately held, or privately owned companies. These issuers cannot list their equity securities with an exchange for secondary-market transactions.

The words "publicly owned company" mean a private-sector issuer that is required by the securities law to register its equity securities with the securities regulator and to communicate reports to the regulator for as long as these securities are regulated by the reporting sections of the law.

All publicly owned companies, also called public companies, are issuers of equity securities that are or may be bought and sold in a public secondary market. Most public companies list their equity securities with an exchange for secondary-market transactions.

Whether a public company lists its equity securities with an exchange or not, usually it does not list its debt securities with an exchange. Even when debt securities are listed with an exchange, most secondary-market transactions in these securities are executed in a dealer market.

In addition to obligations based on common-law principles and nonsecurities laws, public companies have securities-law obligations to the owners of their securities. These securities-law obligations include:

- Compliance with governance standards;
- Maintenance of internal controls for the protection of company-owned assets;
- Communication of reports about the company to the public; and
- Disclosures in connection with certain activities such as the solicitation of proxies. [Note 91]

Governance Standards

The word "governance" means the formulation and administration of policy. That word has been popularized to mean the activities of a corporation's board of directors. Basic governance matters are controlled by the company or corporation law and by a company's or a corporation's constitutional documents. For publicly owned companies, some governance matters are regulated by the securities law.

For purposes of investor protection, the securities law establishes standards for the governance of public companies. Most of these standards can be divided into three categories:

1. The nomination and election of natural persons to the board of directors. The nomination and election process by which persons become directors must be disclosed to stock owners.
2. The composition of the board. A majority of the total number of persons appointed or elected to the board should be independent of the company's officers. Such persons are called independent directors, or nonemployee, nonexecutive, and nonmanagement directors.

3. The structure of the board. The board should establish committees comprised of independent directors and delegate authority to these committees in matters relating to:
   - The nomination of persons for election to the board,
   - Audits of financial statements,
   - Related-party transactions, and
   - Compensation of officers.

The governance of a public company may be regulated directly or indirectly by the securities law. Direct regulation follows from specific language in the law. Indirect regulation may be administered in two ways: (1) by disclosures and (2) by the rules of an exchange.

If the securities law is not specific, and the securities-regulation agency cannot enforce governance standards directly, then the securities regulator may have sufficient authority to require:

- Issuers to make disclosures relating to governance standards. Even if the regulator cannot require issuers to comply with a standard, such as maintaining an audit committee comprised of independent directors, the regulator may require issuers to disclose in annual reports whether they have such committees. That alternative to direct regulation is not satisfactory if direct regulation is appropriate for the protection of investors.
- That exchanges include governance standards in their listing rules. Listing is a private contract between an exchange and an issuer of exchange-listed securities; however, the regulator has the authority to require exchanges to adopt specific rules in the public interest. Such rules may require the issuers of securities to maintain an audit committee comprised of independent directors. Issuers that do not comply with exchange rules are not eligible to list their securities with the exchange. That alternative to direct regulation is not satisfactory because exchanges may or may not enforce their rules.
  [Notes 92–94]

Internal Controls

Publicly owned companies are required by the securities law and regulations to maintain policies and procedures, also called internal controls, which provide reasonable assurances that:

- Activities affecting the company's assets and liabilities are authorized;
- Such activities are recorded in appropriate detail for the purpose of preparing financial statements according to generally accepted accounting principles;
- The company's recorded assets are compared with actual assets from time to time and differences are reconciled; and
- Nonauthorized activities that may have a material effect on the company's financial statements are prevented or detected and corrected in a timely manner.

Internal controls must ensure that audit trails are created and preserved to assist auditors in their review of financial statements. The words "audit trail" mean all electronic and physical records that explain entries in the company's asset, liability, and capital accounts. For a given event, an audit trail should provide satisfactory answers to three questions: Who? Did what? and When?

[Notes 95–96]

Periodic and Event-Driven Reporting

The registration sections of the securities law require issuers to register securities with the securities-regulation agency if such securities are or may be bought and sold in a public secondary market. Some registration sections apply only to debt securities; others apply only to equity securities.

If a security is required to be registered for secondary-market transactions, then that security is regulated by the reporting sections of the law. Most of the reporting sections apply to the issuers of equity securities. These issuers are publicly owned companies and required to communicate reports to the securities regulator periodically and as reportable events occur.

The issuing entity, the directors and officers of the issuer, and accountants and attorneys who advise the issuer may be exposed to civil or criminal penalties if the issuer's registration or reporting disclosures contain information that is not accurate, not complete, or not timely.

The registration and reporting sections of the law do not apply to the issuers of securities that are sold in a private primary market and subsequently are bought and sold in a private secondary market. The distinction between private and public markets is important.

[Note 97]

Solicitation of Proxies

The word "proxy," when used in the securities law, usually means a piece of paper that is to be signed or has been signed by the owner of an equity security. By signing a proxy, also called a proxy card, the owner of a security authorizes a designated natural person to exercise the voting rights of that security according to the written terms of the proxy. Securities regulations authorize electronic proxies and electronic communication of proxies.

To solicit a proxy is to ask a security owner to sign a proxy and send it to the person authorized to vote the security. The owner retains all property rights in the security and retains control of the security in book-entry or physical form. A signed proxy may be revoked before it is voted.

The word "proxy" also means a person other than the owner who is authorized to vote a security. In that sense, a proxy is an agent for the owner.

Voting rights are created by equity securities, but voting rights are not the same for all classes of equity securities. Common stock has one vote for each share; however, if there are multiple classes of stock, then some classes may have more than one vote for each share. Debt securities have no voting rights when they are issued, but the owners of some debt securities may acquire voting rights by the terms and conditions of the indenture.

The board of directors of the issuer of an equity security usually solicits proxies once a year for the purpose of electing directors and securing the approval of stock owners in other matters. The solicitation occurs prior to the annual general meeting of stock owners, and the proxies received are voted at the meeting. The board may also solicit proxies to be voted at a special meeting of stock owners.

The owners of an equity security may solicit proxies from other owners of the same security for the purpose of voting the shares of that security ‘‘no’’ in a matter supported by the board or ‘‘yes’’ in a matter not supported by the board.

An entity other than the issuer may solicit proxies from the owners of an equity security for the purpose of voting the shares of that security ‘‘yes’’ in a proposed acquisition or merger that the issuer’s board does not support. A proposed acquisition or merger supported by the board of the company to be acquired or merged is called a friendly bid. Otherwise, it is called a hostile bid.

The ‘‘owner’’ of a security is an entity or a natural person that:

- Has possession of a security certificate issued in bearer form,
- Is recorded by name in the issuer’s registry of security owners, or
- If not recorded by name in the issuer’s registry, is the beneficial owner of the security.

The words ‘‘record owner’’ or ‘‘owner of record’’ mean an entity or a person that is recorded by name in the issuer’s registry. These owners are:

- Broker-dealers, custodians, settlement-facility depositories, and other fiduciaries that hold securities in their nominee names as agents for beneficial owners, or
- Beneficial owners that hold securities directly.

Proxies are solicited from owners of record; however, beneficial owners not recorded in the issuer’s registry have the right to vote securities in person or by proxy. The securities law and regulations require owners of record that are nominee owners to follow voting instructions from beneficial owners.

Some processes relating to the solicitation and voting of proxies are controlled by company and corporation laws; however, the securities law and regulations establish disclosure standards for the solicitation of proxies from the owners of securities issued by publicly owned companies. These disclosure standards, which apply to issuers and nonissuers, are substantially the same as the standards for the registration of securities and subsequent reports by the issuer. Thus, any entity or person associated with a proxy solicitation may be exposed to civil or criminal penalties if the solicitation contains information that is not accurate, not complete, or not timely.

[Note 98]

SELF-REGULATORY ORGANIZATIONS

In a structure of laws designed to achieve functional regulation of securities, markets, and transactions, the securities law regulates entities and natural persons that provide securities-related services. The law requires most of these entities to be registered with the securities-regulation agency.

Some entities registered with the securities regulator are required to perform the functions of a self-regulatory organization (SRO). Other entities may be required to be a member, or to comply with the rules, of one or more SROs.

There are two categories of SROs:

1. Registered SROs are private-sector entities registered with the securities regulator as a broker-dealer association, or an exchange, or a settlement facility.
2. Special-purpose SROs are private-sector entities authorized by the securities law.

SROs are not the same as industry associations and professional associations. Membership in one or more SROs, or compliance with the rules of an SRO, is mandatory for some registered entities. By contrast, membership in industry and professional associations is voluntary. These voluntary-membership associations are not regulated by the securities law and not responsible for their members' compliance with the law.

The persons appointed or elected to the boards of directors of registered and special-purpose SROs have significant securities-industry experience. That private-sector experience is an important strength of self-regulation. SROs also recruit experienced managers to serve part time on advisory committees that facilitate communications within the industry.

The securities law authorizes the securities regulator to regulate and supervise the activities of registered and special-purpose SROs. Most of the rules established by registered and special-purpose SROs must be approved by the regulator before they can be enforced. These rules must support the regulatory objectives of investor protection, fair and orderly markets, control of systemic risk, and competition.

Among other things, the securities law requires:

- Most broker-dealers to be a member of both a registered broker-dealer association SRO and a special-purpose SRO that administers the securities-account insurance law;
- Some broker-dealers to comply with the rules of a special-purpose SRO that regulates certain government-securities transactions; and
- All public-accounting entities that audit the financial statements of publicly owned companies to be a member of a special-purpose SRO for auditors.

The securities law does not require broker-dealers to be a member of a registered exchange SRO or a member of a registered settlement-facility SRO.

The relationship between the securities regulator (a government agency) and private-sector entities that provide securities-related services is based on the law and regulations.

The relationship between the securities regulator and SROs is based on the law and regulations and on each SRO's rules approved by the regulator.

The relationship between an SRO and its members is based on the SRO's rules, which constitute a private contract. That is an important strength of self-regulation. In response to changing conditions, SROs can interpret their rules and adjust procedures based on their rules. By contrast, the securities regulator may not have the same flexibility in administering its regulations.

The securities law and regulations support the enforcement of SRO rules. An SRO member that violates the SRO's rules may be suspended or expelled by the SRO. When one SRO suspends or expels a member, the rules of other SROs usually require that they, too, suspend or expel that member. The suspension or expulsion of any entity from SRO membership may be sufficient cause for the securities regulator to suspend or revoke that entity's registration. An entity is prohibited from providing securities-related services after its registration with the securities regulator is suspended or revoked.

SROs should be financially self-sufficient: Their current expenses and capital expenditures should be paid from membership, examination, market information, and transaction fees and from money-amount penalties collected from members that violate SRO rules. Financial independence allows SROs to avoid the layers of financial and operational controls that apply to government agencies.

[Notes 99–103]

REGISTERED SELF-REGULATORY ORGANIZATIONS

There are two categories of self-regulatory organizations (SROs): (1) registered SROs and (2) special-purpose SROs.

SROs registered with the securities-regulation agency include one or more private-sector entities registered as:

- A broker-dealer association, or
- An exchange, or
- A settlement facility.

Registration is specific to an entity and has no termination date.

Registered SROs are entities created by the authority of company or corporation laws for purposes stated in their constitutional documents. Registered SROs may be nonprofit entities owned by and operated for the benefit of their members, or commercial entities owned by and operated for the benefit of their equity-security owners.

The natural persons who comprise the board of directors of a registered SRO are elected by the SRO's members or by equity-security owners according to the SRO's constitutional documents. The securities law and regulations may prescribe the proportion or minimum number of independent directors and establish standards for the representation of members.

Commercial-entity SROs may be privately owned, or publicly owned, or subsidiaries of publicly owned companies. The equity securities issued by publicly owned companies must be registered with the securities regulator and may be listed with an exchange for secondary-market transactions. The securities issued by a publicly owned exchange, or by a publicly owned company that is affiliated with an exchange, may be listed for trading on that exchange.

The securities law prescribes the requirements for initial and continued registration of SROs with the securities regulator.

[Notes 104–105]

Broker-Dealer Association SROs

The securities law delegates authority to the securities-regulation agency to register one or more securities associations, also called broker-dealer associations, and to regulate and supervise the activities of such associations. An association provides services to its members and, at the same time, performs the functions of an SRO as required by the law and regulations. An association is not a broker or dealer in the execution of transactions, nor is it an agent or a principal in the settlement of transactions.

Most broker-dealers are required to be registered with the securities regulator. Most registered broker-dealers are required to be a member of a broker-dealer association that is an SRO. Membership in a broker-dealer association SRO is limited to registered broker-dealers.

The concept of an SRO for broker-dealers emerged in the late 1930s, when it became obvious that the then-current model for regulation was not the best way to support capital formation and the protection of investors. That model ignored dealer markets and securities not listed with an exchange. Regulated markets were exchanges, and each exchange regulated only its members. Securities-law amendments over the years have authorized the securities regulator and broker-dealer association SROs to regulate nonexchange markets and brokers and dealers not members of an exchange. A broker-dealer association can support some regulatory objectives more effectively than an exchange.

There may be two or more broker-dealer association SROs regulated by the same securities law and the same securities regulator; however, the public interest usually is not served by multiple associations or by competition between associations.

[Note 106]

Exchange SROs

The securities law delegates authority to the securities-regulation agency to register one or more exchanges and to regulate and supervise the activities of such exchanges. An exchange provides transaction-execution services to its members and, at the same time, performs the functions of an SRO as required by the law and regulations. Both alternative trading systems and exchanges provide transaction-execution services, but only exchanges are SROs. An exchange is not a broker or dealer in transactions and does not provide transaction-settlement services.

Most broker-dealers are required to be registered with the securities regulator. Membership in an exchange SRO is limited to registered broker-dealers.

Broker-dealers registered with the securities regulator are eligible for membership in an exchange SRO; however, exchange membership is not a condition of broker-dealer registration. A broker-dealer may choose to be a member of one or more exchanges, or choose not to be a member of an exchange.

If a broker-dealer chooses to execute transactions only in nonexchange markets, or chooses to buy the services of one or more exchange members to execute the broker-dealer's exchange-market transactions, then that broker-dealer is not regulated by an exchange. A broker-dealer that chooses to be a member of an exchange may or may not be a member of a settlement facility; that is, settlement-facility membership is not a condition of exchange membership.

In the early development of securities markets, exchanges were self-regulators of various activities at the same time. The rules of an exchange often:

- Governed both the execution and the settlement of exchange transactions;
- Fixed the minimum commissions members charged their customers for executing exchange transactions; and
- Prohibited members from buying or selling listed securities in off-exchange transactions.

That form of self-regulation resulted in conflicts of interest. Exchanges used their regulatory authority to limit competition but did not use their regulatory authority to prevent or stop illegal practices by members.

There may be two or more exchange SROs regulated by the same securities law and the same securities regulator. Competition among transaction-execution facilities serves the public interest; however, exchanges should compete as markets, not as regulators.

[Note 107]

Settlement-Facility SROs

The securities law delegates authority to the securities-regulation agency to register one or more clearing agencies, also called settlement facilities, and to regulate and supervise the activities of such facilities. A settlement facility provides transaction-settlement services to its members and, at the same time, performs the functions of an SRO as required by the law and regulations. A settlement facility does not provide transaction-execution services.

Membership in a settlement-facility SRO is not limited to broker-dealers registered with the securities regulator. Banks, insurance companies, and other entities not registered with the securities regulator are eligible for settlement-facility membership. A precondition for cost-efficient settlement is the separation of settlements from the control of exchanges. Then settlement facilities can respond directly to the interests of members from different sectors of the financial-services industry.

Broker-dealers registered with the securities regulator are eligible for membership in a settlement-facility SRO; however, settlement-facility membership is not a condition of broker-dealer registration. A broker-dealer may choose to be a member of one or more settlement facilities or choose not to be a member of a settlement facility.

If a broker-dealer chooses to buy the services of one or more facility members to settle the broker-dealer's transactions executed in dealer markets and exchange markets, then that broker-dealer is not regulated by a settlement facility. A broker-dealer that chooses to be a member of a settlement facility may or may not be a member of an exchange; that is, exchange membership is not a condition of settlement-facility membership.

In the late 1960s, the infrastructure for settling securities transactions created significant costs and risks for broker-dealers and investors. Changes were made in the 1970s, including the introduction of securities-account insurance and the regulation of settlement facilities, but it was not until after the global collapse of equity-securities prices in 1987 that government agencies and private-sector entities implemented international standards for settlements.

There may be two or more settlement-facility SROs regulated by the same securities law and the same securities regulator. That occurs when settlement facilities specialize in different types of securities or different types of transactions. One facility settles transactions in equity securities, another settles transactions in debt securities. One facility settles transactions by net delivery and net payment, another settles transactions by gross delivery and gross payment.

There are opportunities for significant economies of scale and credit-risk reduction when the maximum number of transactions is settled by one facility. At the same time, however, there may be both legal and practical problems associated with the operation of a super-facility.

Entities that settle transactions in private-sector securities are not government "agencies."

[Note 108]

SPECIAL-PURPOSE SELF-REGULATORY ORGANIZATIONS

There are two categories of self-regulatory organizations (SROs): (1) special-purpose SROs and (2) registered SROs.

Special-purpose SROs include any private-sector, nonprofit entity authorized by the securities law to regulate and supervise:

- Public accountants that audit the financial statements of publicly owned companies, or
- Transactions in certain government-issued securities, or
- Administration of the securities-account insurance law.

The securities-law authority for a special-purpose SRO is specific to an entity and has no termination date.

Special-purpose SROs are entities created by the authority of company or corporation laws for purposes stated in their constitutional documents. The natural persons who comprise the boards of directors of special-purpose SROs are appointed directly or indirectly by the government. The terms and conditions connected with such appointments usually are stated in the law.

The authority, functions, and structure of a special-purpose SRO are defined and described in the law. The law also establishes the authority of the securities-regulation agency in relation to the activities of special-purpose SROs.

Each SRO employs persons with qualifications and experience relating to those sections of the law administered by the SRO. An SRO that regulates public-accounting entities must have a staff that is qualified to formulate and administer generally accepted auditing standards and to review the audits performed by members to ensure that members comply with auditing standards. An SRO that administers the securities-account insurance law must have a staff that is qualified to assess the financial condition of member broker-dealers and to interpret the bankruptcy, commercial, and securities laws.

Because of the narrow scope and specialized functions of a special-purpose SRO, it is not practical to authorize competing entities. Each SRO is a regulated monopoly.

[Notes 109–113]

REGULATION OF REGISTERED ENTITIES AND PERSONS

In a structure of laws based on functional regulation, the securities law requires most entities that provide securities-related services to be registered with the securities-regulation agency or other regulators. Entities that provide securities-related services include:

- Accountants that audit the financial statements of publicly owned companies;
- Broker-dealer associations;

- Brokers and dealers;
- Credit-rating companies;
- Exchanges;
- Investment advisers and investment companies;
- Securities-information processors;
- Settlement facilities; and
- Transfer agents.

The securities law requires some natural persons associated with broker-dealers to be registered with a self-regulatory organization (SRO).

Even when an entity or a person is not required to be registered with the securities regulator or an SRO, that entity's or person's securities-related activities may be regulated by the securities law.

Auditors

Independent public accountants, among other things, provide accounting advice and auditing services to:

- Issuers of securities;
- Entities that provide securities-related services; and
- Other entities when their activities are regulated.

In matters relating to issuers that are publicly owned companies, the securities law:

- Requires these companies to communicate prescribed information, including financial statements, to the securities-regulation agency;
- Authorizes the securities regulator to prescribe the form of financial statements;
- Authorizes the regulator to establish accounting principles and auditing standards applicable to financial statements; and
- Authorizes the regulator to require that certain financial statements be audited by independent public accountants.

The financial statements audited by accountants are an important source of information for the public and for regulators.

There is a public interest in the equal regulation of, and competition among, accountants that audit the financial statements of publicly owned companies. There is a parallel public interest in the competence, ethical behavior, and independence of public accountants that advise others in matters relating to financial reporting and disclosures. For these reasons, entities that audit the financial statements of public companies are regulated by the securities law.

In matters relating to auditors, the securities law:

- Requires entities that audit the financial statements of publicly owned companies to be a member of an SRO for auditors;
- Requires each member of the auditors' SRO to communicate prescribed information initially and periodically to the SRO;

- Requires the SRO to maintain a program of examinations for the purpose of assessing the compliance of members with the law and regulations, generally accepted accounting principles, generally accepted auditing standards, and SRO rules; and
- Authorizes the SRO to penalize members and natural persons associated with members for violations of the law, regulations, and SRO rules.

The securities law does not control the certification of persons as accountants; that is, the law does not establish formal education, or experience, or testing as prerequisites for the practice of accounting and auditing. These matters are administered by an association of accountants, called an accountancy board, authorized by a law-making body to establish and enforce professional standards for public accountants.

Public-accounting entities required to be a member of an auditors' SRO may choose to be a member of one or more professional associations that are not SROs.

[Notes 114–115]

Broker-Dealer Associations

A broker-dealer association registered with the securities-regulation agency is an SRO that regulates and supervises the primary-market and secondary-market activities of its members.

Broker-dealers registered with the securities regulator are required to be a member of a broker-dealer association SRO. All members of a broker-dealer association SRO are required to be registered with the regulator.

A broker-dealer association does not:

- Create securities accounts for its members or its members' customers, or
- Make investment recommendations, or
- Become an agent or a principal in the execution or settlement of transactions, or
- Guarantee the settlement of transactions, or
- Provide after-settlement services.

A broker-dealer association may be a securities-information processor.

There is a public interest in the equal regulation of, and competition among, brokers and dealers that provide securities-related services, whether they are members of an exchange or members of a settlement facility or not. For that reason, associations of broker-dealers are regulated by the securities law.

Among other things, the securities law requires a broker-dealer association to be registered with the securities-regulation agency and to:

- Perform the functions of an SRO;
- Comply with the law, regulations, and association rules;
- Enforce compliance by its members with the law, regulations, and association rules; and
- Communicate prescribed information initially and periodically to the securities regulator.

Further, the securities law authorizes the securities regulator to:

- Penalize an association for violations of the law, regulations, and association rules, and
- Remove from office or penalize any director or officer of an association for willful misconduct or failure to enforce compliance with the law, regulations, and association rules.

In addition to membership in a broker-dealer association SRO, as required by the securities law, broker-dealers may choose to be a member of one or more exchange SROs and one or more settlement-facility SROs.

[Notes 116–117]

Brokers and Dealers

A private-sector entity that performs the functions of a securities broker, or a securities dealer, or both, is called a broker-dealer. Broker-dealers execute transactions in private markets, or public markets, or both. In that context:

- A broker is an agent regularly engaged in the business of executing orders from customers to buy and sell securities, for the customer's account and risk, in primary markets and secondary markets.
- A dealer is a principal regularly engaged in the business of executing transactions to buy and sell securities, for the dealer's account and risk, in primary markets and secondary markets.

In a structure of laws based on functional regulation, broker-dealers are regulated by the securities law. The scope of services offered by a broker-dealer may include:

- Providing corporate-finance advice relating to acquisitions, combinations, divestitures, mergers, and other activities that involve buying, exchanging, and selling securities;
- Buying (also called underwriting) and selling securities in primary markets as a principal;
- Buying and selling structured securities and structured transactions as a principal;
- Buying and selling securities in secondary markets as a principal;
- Recommending suitable investments for customers;
- Executing and settling securities transactions as an agent for customers;
- Borrowing and lending securities;
- Lending money to customers for the purpose of financing customer-owned securities;
- Providing after-settlement services for customers that own securities; and
- Providing execution, settlement, and after-settlement services to other broker-dealers.

Some broker-dealers limit their activities to providing corporate-finance advice relating to buying, exchanging, and selling securities; that is, they do not underwrite the distribution of securities that may result from that advice.

A broker-dealer creates a ‘‘securities account,’’ as defined in the commercial law, for each customer. Then:

- Money received by a broker-dealer for a customer’s account is held in a bank account controlled by the broker-dealer until the customer withdraws the money or uses it to buy securities.
- Securities received by a broker-dealer for a customer’s account are held in a securities-depository account controlled by the broker-dealer until the customer sells the securities or until the maturity value of a debt security is paid.

Some transactions executed by a broker or dealer for or with a customer are not settled in a customer’s account controlled by that broker or dealer. Instead, the money and securities are settled in the customer’s account with the customer’s custodian.

Some broker-dealers, called introducing brokers, do not hold customer-owned money or securities. The money and securities of an introducing broker’s customers, while controlled by the introducing broker, are held by another broker, called a settlement broker. The settlement broker creates separate ‘‘disclosed’’ accounts for each of an introducing broker’s customers or creates one ‘‘omnibus’’ account for a number of an introducing broker’s customers. Settlement brokers take instructions relating to these accounts from the introducing broker.

Broker-dealers may operate a transaction-execution facility called an alternative trading system (ATS). An ATS performs the order-matching functions of an exchange, but an ATS is not regulated as an exchange. An entity that operates an ATS must be registered with the securities regulator as a broker-dealer.

There is a public interest in the financial responsibility of broker-dealer entities and in the competence and ethical behavior of natural persons employed by broker-dealers. For these reasons, broker-dealers are regulated by the securities law.

Among other things, the securities law requires most:

- Brokers and dealers to be registered with the securities-regulation agency;
- Registered broker-dealers to be a member of a broker-dealer association that is an SRO; and
- Registered broker-dealers to be a member of a securities-account insurance SRO.

Further, the securities law requires registered broker-dealers to:

- Communicate prescribed information initially and periodically to the securities regulator;
- Comply with regulations relating to government-securities transactions;
- Maintain a prescribed amount or more of regulatory capital;
- Protect customer-owned assets controlled by the broker-dealer;
- Establish and enforce policies and procedures designed to prevent the use of material nonpublic information in any way that violates the law;
- Ensure that associated persons are registered with an SRO; and
- Supervise the activities of associated persons.

The securities law authorizes the regulator to penalize a broker-dealer entity and persons associated with a broker-dealer for violations of the law and regulations.

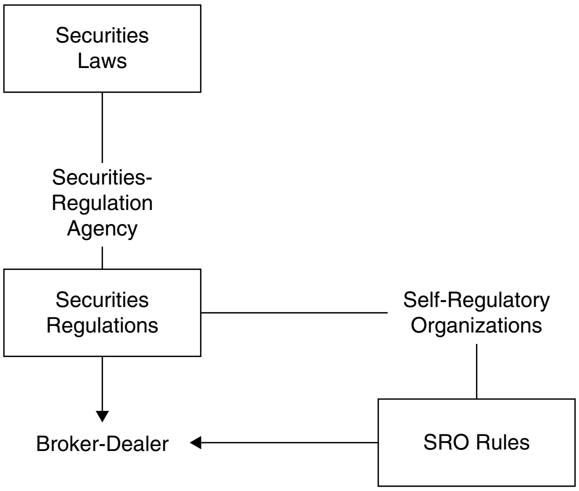

EXHIBIT 1.8 Regulation of a Broker-Dealer Entity

The regulation of a broker-dealer is shown in Exhibit 1.8.

In addition to membership in a broker-dealer association SRO and a securities-account insurance SRO, as required by the securities law, registered broker-dealers may choose to be a member of one or more exchange SROs and one or more settlement-facility SROs.

Broker-dealers may choose to be a member of one or more industry associations that are not SROs.

[Notes 118–125]

Credit-Rating Companies

Credit-rating companies often are called agencies; however, they are not government agencies and not commercial agents in any sense of that word. A credit-rating company is a private-sector entity operated for the purpose of making a profit from selling information about credit risks.

In that context, ‘‘credit risk’’ means the risk of financial loss to the owner of a security if the issuer or the issuer’s guarantor does not perform the payment obligations of that security.

Credit-rating companies use proprietary methods to estimate the probabilities of payment defaults by government and private-sector entities that issue or guarantee securities. They also evaluate the risk characteristics of specific securities. The purpose of these evaluations is to predict whether interest, principal, and preferred dividends will be paid to the security owners when such payments become due.

Future-payment predictions are expressed as credit ratings. A high bond rating (such as AAA or Aaa) means a high probability of full and timely payments, while a low bond rating (such as BB or Ba-2) means a significantly lower probability of full and timely payments. Each credit-rating company establishes its own scale of ratings for both government and private-sector issuers and securities. An asset-backed security may have a higher rating than the rating assigned to the issuer of that security. Ratings may be changed, higher or lower, from time to time. Securities with high ratings are called investment grade. Those with low ratings are called speculative grade or junk.

Credit ratings apply to:

- Money-market securities that have original-issue maturities of one year or less;
- Bonds and notes that have original-issue maturities of more than one year;
- Classes of preferred stock that pay money-amount dividends; and
- Insurance companies that guarantee payments on securities issued by others.

Credit ratings and changes in credit ratings are important information for investors when they consider buying, or holding, or selling debt securities and preferred equity securities.

Law-making bodies may use credit ratings to classify securities for regulatory purposes. Broker-dealers are required by the securities-regulation agency to use credit ratings in calculating their regulatory capital. If a security owned by a broker-dealer has a low credit rating, then the value of that security is decreased for purposes of calculating the broker-dealer's regulatory capital. Banking-regulation agencies use credit ratings for similar purposes. References to credit ratings often are included in master agreements between transaction counterparties, in the indentures of debt securities, and in contracts between the borrowers and lenders of money and securities.

Credit ratings are not predictions relating to common stocks. A high credit rating assigned to an issuer's debt securities is not a prediction that the issuer's common-stock price will increase. Nor is it a prediction that the issuer will maintain or increase the money-amount dividends paid on its common stock.

There is a public interest in the equal regulation of, and competition among, credit-rating companies. There is a parallel public interest in the technical competence, ethical behavior, and independence of such organizations. For these reasons, some credit-rating companies are regulated by the securities law.

The securities law allows qualified credit-rating companies, if they apply, to be registered with the securities regulator.

Among other things, the securities law requires registered credit-rating companies to:

- Establish and enforce policies and procedures designed to prevent the use of material nonpublic information in any way that violates the law;
- Establish and enforce policies and procedures designed to manage conflicts of interest if such conflicts arise; and
- Communicate prescribed information initially and periodically to the securities regulator.

The law authorizes the securities regulator to:

- Register an applicant as a credit-rating company if it finds that the applicant has complied with the law and relevant regulations;
- Establish regulations that prohibit anti-competitive practices by credit-rating companies; and
- Penalize credit-rating companies and persons associated with these companies for violations of the law and regulations.

Further, the law prohibits:

- The regulator from prescribing credit ratings or the technical procedures by which credit ratings are determined, and
- A credit-rating company from representing to the public that the regulator recommends the company or certifies the company's credit-rating performance.

The securities law does not require a registered credit-rating company to be a member, or to comply with the rules, of a self-regulatory organization.

Credit ratings are not the same as investment-performance ratings. Companies that publish investment ratings evaluate the actual investment results of a number of investment managers during a given period, such as three months or three years, and then rank the managers in terms of their relative performance during that period. These rankings are accompanied by an explicit statement that past performance is not a reliable prediction of future performance.

[Notes 126–133]

Exchanges

An exchange registered with the securities-regulation agency is an SRO that regulates and supervises a public secondary market for the execution of transactions by and between its members.

An exchange does not regulate or supervise the offer and sale of securities in primary-market transactions.

All exchange transactions are executed by members as principals, even when one or both members are agents for customers. An exchange may establish rules by which exchange members ''sponsor'' customers that enter orders directly into the exchange's order-matching system. The sponsoring member is responsible to the exchange for sponsored-customer orders and for settlements of the resulting transactions.

Broker-dealers registered with the securities regulator are not required to be a member of an exchange SRO. All members of an exchange SRO are required to be registered as a broker-dealer with the regulator.

The two parts of a security transaction are (1) execution and (2) settlement:

- Execution occurs when a buyer and seller agree on a price the buyer will pay to acquire ownership of a certain amount of a security. Transactions are executed in dealer markets or in direct-issue markets, or through transaction-execution facilities such as alternative trading systems and exchanges. Transactions also are executed by the terms and conditions of a public bid.
- Settlement occurs when the agreed amount of a security is delivered from seller to buyer and the agreed amount of money is paid from buyer to seller.

An exchange does not:

- Create securities accounts for its members or its members' customers, or
- Make investment recommendations, or

- Become an agent or a principal in the execution or settlement of transactions, or
- Guarantee the settlement of transactions, or
- Provide after-settlement services.

An exchange may be a securities-information processor.

There is a public interest in the equal regulation of markets that are exchanges and markets that are not exchanges. There is a parallel public interest in competition among markets. For these reasons, exchanges are regulated by the securities law.

Among other things, the securities law requires most exchanges to be registered with the securities regulator and requires registered exchanges to:

- Perform the functions of an SRO;
- Comply with the law, regulations, and exchange rules;
- Enforce compliance by its members with the law, regulations, and exchange rules; and
- Communicate prescribed information initially and periodically to the securities regulator.

Further, the securities law authorizes the regulator to:

- Penalize an exchange for violations of the law, regulations, and exchange rules, and
- Remove from office or penalize any director or officer of an exchange for willful misconduct or failure to enforce compliance with the law, regulations, and exchange rules.

In that context:

- Securities are registered for secondary-market transactions by the issuer with the securities regulator according to the law and regulations.
- Securities registered with the regulator may be listed by the issuer with one or more exchanges according to the rules of each exchange; however, securities registered with the regulator are not required to be listed with an exchange.
- Securities registered with the regulator and listed by the issuer with at least one exchange may be listed by other exchanges without the issuer's application for listing.
- Transactions in listed securities, if executed on an exchange, are executed by and between exchange members according to exchange rules. The details of these transactions are communicated by the exchange to a settlement facility that delivers securities and pays money between facility members according to facility rules.
- After the details of an exchange transaction are accepted by a settlement facility, the exchange is not involved in the settlement of that transaction. An exchange member that executes an exchange transaction may or may not be a facility member that settles that transaction.

An exchange cannot create restrictive rules for the purpose of gaining a monopoly on the secondary-market transactions of securities listed by issuers with that exchange. Exchange members may buy and sell listed securities in a dealer market, on the exchange where the issuer listed the security, or on another exchange that has listed that security.

Broker-dealers may choose to be a member of one or more exchange SROs and one or more industry associations that are not SROs.

[Notes 134–137]

Investment Advisers

As a generalization, there are three categories of investment advisers:

1. Entities and natural persons that are compensated by their customers for investment recommendations. These advisers are not authorized by their customers to execute transactions for a customer's account and risk.
2. Entities and persons that are compensated by their customers for managing the customers' assets continuously according to the customers' instructions. These advisers make investment recommendations and, with a customer's prior approval, execute transactions for the customer's account and risk.
3. Entities and persons that are compensated by their customers for managing the customers' assets continuously. These advisers are authorized by their customers to make investment decisions and to execute transactions for a customer's account and risk. The adviser has ''discretion'' in managing a customer's assets, meaning that a customer's prior approval is not necessary for the execution of transactions.

Advisers manage the assets of:

- Commercial and nonprofit entities;
- Government agencies;
- Individual investors;
- Investment trusts;
- Private (not registered) investment companies and partnerships;
- Public (registered) investment companies; and
- Retirement-income plans.

Advisers, if authorized, execute transactions through brokers and with dealers. These transactions are settled in customers' accounts with broker-dealers and custodians, or in customers' accounts controlled by an adviser.

There is a public interest in the equal regulation of, and competition among, investment advisers. There is a parallel public interest in the competence and ethical behavior of advisers that receive compensation for investment recommendations and for managing the assets of investors. For these reasons, investment advisers are regulated by the securities law.

Among other things, the securities law requires:

- Some investment advisers to be registered with the securities-regulation agency;
- Each registered adviser to protect customer-owned assets controlled by the adviser;
- Each adviser to establish and enforce policies and procedures designed to prevent the use of material nonpublic information in any way that violates the law; and
- Each adviser to communicate prescribed information initially and periodically to the securities regulator, or customers, or both.

The securities law also:

- Regulates related-party transactions and the terms of investment-advisory contracts, and
- Prohibits an adviser from representing to the public that the regulator recommends the adviser or certifies the adviser's investment performance.

Further, the law authorizes the regulator to penalize advisers and natural persons associated with advisers for violations of the law and regulations.

The securities law does not require an investment adviser to be a member, or to comply with the rules, of an SRO.

Advisers and persons associated with advisers may choose to be members of one or more industry associations or professional associations that are not SROs.

[Notes 138–147]

Investment Companies

Investment companies are entities that issue equity securities. An investment company may issue these securities:

- For sale only in a public primary market. Both the investment company and its issued securities are required by the securities law to be registered with the securities-regulation agency. An investment company registered under the securities law is a publicly owned company.
- For sale only in a private primary market. Both the investment company and its issued securities are exempted from the registration and reporting sections of the securities law.

All or most of the money received from the sale of an investment company's issued securities is used by the company to buy investment securities issued by other entities. As the value of securities bought by the investment company decreases or increases, so, too, will the value of securities issued by the investment company decrease or increase.

An investment company is usually organized by another entity that is an investment adviser. The investment company's board of directors then hires that adviser to manage continuously the company's assets according to the terms of an investment-advisory contract. One adviser may organize or be affiliated with a number of investment companies, each called a fund. Funds may have different investment objectives. Some invest only in long-term debt securities, some invest only in equity securities, and some invest in both. Money-market funds invest only in short-term debt securities with the highest credit ratings. A number of funds managed by one adviser is called a fund complex or a family of funds.

The four most common structures for investment companies are:

1. Registered open-end funds, also called mutual funds. The fund entity issues and sells new securities continuously to the public at the fund's daily net-asset value, which may fluctuate. The fund entity also buys its previously sold securities continuously from the public at the same daily net-asset value. Fund-issued securities are not traded in a secondary market.
2. Registered open-end funds, also called exchange-traded funds. The fund entity issues and sells new securities from time to time to the public and lists these securities with an exchange for secondary-market trading. Fund-issued securities are bought and sold in exchange transactions at the current market price, which may fluctuate.
3. Registered closed-end funds. The fund entity issues and sells a fixed amount of securities to the public and lists these securities with an exchange for secondary-market trading. Fund-issued securities are bought and sold in exchange transactions at the current market price, which may fluctuate.

4. Nonregistered private investment funds, often called hedge funds or private-equity funds. These funds usually are organized as partnerships with a small number of partners. Because the issued securities are not intended to be sold in a public primary market or traded in a public secondary market, both the issuer and the securities are exempt from registration. The issued securities are bought and sold in private transactions according to the terms and conditions of the partnership agreement.

The owners of securities issued by an investment company own the investment company, not the investment securities owned from time to time by that company. An investment company maintains a registry of security owners for the company's issued securities, but it does not create securities accounts for the owners of issued securities.

An investment company usually has no employees. The functional activities of an investment company are performed by affiliated entities or independent contractors, such as:

- Investment advisers that have discretion to buy and sell investment securities continuously for the company's account and risk according to the terms of an investment-advisory contract;
- Brokers and dealers that execute and settle transactions in investment securities on instructions from the company's adviser;
- Custodians that hold company-owned money and investment securities;
- Brokers that sell securities issued by the company;
- Transfer agents that provide services relating to securities issued by the company;
- Independent public accountants that audit the company's financial statements; and
- Attorneys who advise the company on compliance and legal matters.

There is a public interest in the equal regulation of, and competition among, investment companies. There is a parallel public interest in the competence, ethical behavior, and objectivity of the directors of investment companies and in the competence and ethical behavior of investment advisers that manage the assets of investment companies. For these reasons, investment companies that issue securities for sale in a public market are regulated by the securities law.

Among other things, the securities law requires:

- Some investment companies to be registered with the securities-regulation agency;
- Each registered company that intends to sell issued securities in a public market to register such securities with the securities regulator;
- Each company to protect its assets; and
- Each company to communicate prescribed information initially and periodically to the regulator.

The securities law also:

- Regulates related-party transactions and the terms of investment-advisory contracts, and
- Prohibits a company from representing to the public that the regulator recommends the company or certifies the investment merits of securities issued by the company.

Further, the law authorizes the regulator to penalize investment companies and natural persons associated with these companies for violations of the law and regulations.

The securities law does not require an investment company to be a member, or to comply with the rules, of an SRO. An investment company may choose to be a member and to comply with the rules of a settlement-facility SRO.

Investment companies may choose to be a member of one or more industry associations that are not SROs.

[Notes 148–155]

Securities-Information Processors

The continuous and timely communication of securities prices from transaction counterparties to the public is essential for price transparency and the maintenance of fair and orderly markets.

A securities-information processor (SIP) is a private-sector entity that:

- Collects real-time quotation and transaction prices from public secondary markets, and
- Communicates these prices directly or indirectly to brokers, dealers, financial news services, investment advisers, investors, and others.

In that context:

- Quotation prices are the current bids and offers by potential buyers and sellers, and
- Transaction prices are the actual prices agreed by buyers and sellers.

Broker-dealer associations and exchanges that communicate prices directly or indirectly to the public are registered SROs. There is no reason for these SROs to be regulated separately as SIPs. By contrast, non-SRO SIPs are required by the securities law to be registered with the securities-regulation agency if the SIP has exclusive rights to collect prices from public markets and to control the communication of these prices to the public.

An SIP does not:

- Create securities accounts.
- Make investment recommendations.
- Execute or settle transactions.
- Provide after-settlement services.

There is a public interest in the equal regulation of markets to ensure public access to accurate, complete, and timely prices that reflect supply and demand for specific securities. For that reason, exclusive SIPs are regulated by the securities law.

Among other things, the securities law:

- Requires entities (other than SROs) to be registered as SIPs with the securities regulator if they have exclusive rights to collect price information from public secondary markets.
- Authorizes the securities regulator to penalize SIPs for violations of the law and regulations.

The securities law does not require a registered SIP to be a member, or to comply with the rules, of an SRO.

Broker-dealer associations and exchanges may sell quotation and transaction prices to SIPs. The amount of money received for that information may be an important source of income for an association or exchange. That is a controversial subject. It has been argued that such payments should belong to the brokers and dealers that direct orders to markets and thereby create the quotations and prices bought by information processors.

[Notes 156–160]

Settlement Facilities

A settlement facility registered with the securities-regulation agency is an SRO that regulates and supervises the settlement of transactions for which its members are responsible. These transactions are executed in both primary markets and secondary markets.

Broker-dealers registered with the securities regulator are not required to be a member of a settlement facility. Membership in a settlement facility is not limited to broker-dealers registered with the securities regulator or to broker-dealers that are members of an exchange.

The two parts of a security transaction are execution and settlement:

1. Execution occurs when a buyer and seller agree on a price the buyer will pay to acquire ownership of a certain amount of a security.
2. Settlement occurs when the agreed amount of a security is delivered from seller to buyer and the agreed amount of money is paid from buyer to seller. Transactions are settled directly between buyers and sellers and indirectly through settlement facilities. The word "clearing" has been popularized to mean "settlement"; however, clearance is the calculation of delivery and payment obligations prior to settlement, not the act of settlement.

A settlement facility may:

- Create securities accounts for its members,
- Become an agent or a principal in the settlement of transactions, and
- Provide after-settlement services.

Practically all equity-securities transactions executed through exchanges are settled by settlement facilities. By contrast, practically all debt-securities transactions settled by settlement facilities are not executed through exchanges.

The scope of services provided by a settlement facility to its members may include:

- Preclearance matching and confirmation of executed-transaction data;
- Clearance (the calculation of delivery and payment obligations).
- Borrowing securities from members and lending securities to members for settlement;
- Settlement as an agent or a principal; and
- After-settlement custody of securities and related services.

After the details of executed transactions are communicated to and accepted by a settlement facility, these transactions are settled in the accounts of facility members according to facility rules.

Settlement-facility services are provided to members that:

- Execute transactions as agents or principals in primary and secondary markets. The details of these transactions are communicated to the facility for acceptance and settlement.
- Accept responsibility for transactions executed by certain nonmembers. The details of these transactions are communicated to the facility for acceptance and settlement. Members that settle transactions executed by nonmembers are called clearing brokers or prime brokers. Clearing brokers and prime brokers are settlement brokers.

Settlement facilities may or may not be securities depositories.

A settlement facility that is a securities depository:

- Creates securities accounts for its members;
- Holds member-owned securities and members' customer-owned securities in these accounts;
- Notifies the issuers of these securities, or their transfer agents, to record ownership of the securities in the depository's nominee name; and
- Provides after-settlement services to its members.

A settlement facility that is not a depository:

- Offsets each member's obligations to make or take delivery of the same security on the same day, and
- Communicates the net amount of deliveries to a depository that adjusts the securities accounts maintained by the depository for its members.

Most deliveries of securities by a depository do not require changes in the names of owners recorded in an issuer's registry of security owners. These securities usually are recorded in the registry under the nominee name of the depository; that is, the depository is the owner of the securities. On the regular settlement date, the depository delivers securities internally by book entries to or from the accounts of its members. On the same day, members deliver securities internally by book entries to or from their proprietary accounts and to or from their customers' accounts.

One settlement facility may be a member of another settlement facility.

Some facilities, to reduce the costs and risks of settlements for their members, become a counterparty by novation in transactions accepted for settlement; that is, the facility settles transactions as a principal with its members. Facilities that settle transactions as a principal by novation incur credit risks and related systemic risk. For that reason, such facilities establish risk-management policies and procedures to control the risks resulting from transactions accepted for settlement. These facilities establish settlement funds and require contributions to the funds by members. Losses resulting from delivery or payment defaults by members are paid from the settlement fund. As a result, such losses are distributed among nondefaulting members.

There is a public interest in the equal regulation of securities-settlement services available to banks, broker-dealers (both members and nonmembers of exchanges), insurance companies, investment companies, settlement facilities, and others. For that reason, settlement facilities are regulated by the securities law.

A settlement facility regulated by the securities regulator, and regulated as a limited-purpose bank by a banking-regulation agency, may participate in a national system for inter-bank payments. If a facility does not have direct access to inter-bank payments, then it must make payments to and receive payments from its members through a number of banks that hold accounts for both the facility and its members.

Among other things, the securities law requires most settlement facilities to be registered with the securities regulator and requires registered facilities to:

- Perform the functions of an SRO;
- Comply with the law, regulations, and facility rules;
- Enforce compliance by its members with facility rules; and
- Communicate prescribed information initially and periodically to the securities regulator.

The law also authorizes a facility to close summarily the accounts of a member that has been suspended or expelled by another SRO, or is in default of any settlement obligation to the facility, or is known to be operating under difficult financial conditions.

Further, the securities law authorizes the regulator to:

- Penalize a facility for violations of the law, regulations, and facility rules, and
- Remove from office or penalize any director or officer of a facility for willful misconduct or failure to enforce compliance with facility rules.

Broker-dealers may choose to be a member of one or more settlement-facility SROs and one or more industry associations that are not SROs.

[Notes 161–165]

Transfer Agents

The words "registrar" and "transfer agent" were used interchangeably some years ago, but the use of the word "registrar" has decreased.

There are two categories of transfer agents:

1. Some transfer agents sell their services to other entities that are the issuers of securities. The activities of these transfer agents and issuers are governed by the commercial law. If the issuers that buy transfer-agent services are publicly owned companies, then the transfer agents are regulated by the securities law.
2. Some issuers perform the functions of a transfer agent internally only for the securities they issue. The activities of these issuers are governed by the commercial law, but their transfer-agent activities are not regulated by the securities law.

The services provided by both external and internal transfer agents usually include:

- Controlling the issuance and preventing the nonlegal issuance of securities;
- Recording changes in the ownership of issued securities;
- Adjusting the amount of issued securities after stock dividends, splits, and reverse splits;

- Canceling, converting, and exchanging issued securities; and
- Generally ensuring the accuracy of the issuer's registry of security owners.

The names of security owners are recorded by a transfer agent in the issuer's registry of security owners. The registry establishes the ownership of securities, but the owners recorded in the registry may or may not be beneficial owners.

Most external transfer agents are banks and the same banks may hold securities as custodians; however, the services of a transfer agent are not the same as the services of a custodian. A bank provides transfer-agent services to the issuers of securities. By contrast, a bank provides custodial services to the owners of securities.

There is a public interest in the equal regulation of, and competition among, bank and nonbank transfer agents that provide services to publicly owned companies. There is a parallel public interest in accurate, efficient, and timely changes in the ownership of securities resulting from corporate actions and from the settlement of transactions. For these reasons, some transfer agents are regulated by the securities law.

Among other things, the securities law requires:

- Transfer agents to be registered with a banking-regulation agency or the securities-regulation agency if the transfer agent provides services to another entity that issues securities registered with the securities regulator;
- Each registered transfer agent to communicate prescribed information initially and periodically to the appropriate banking regulator or securities regulator; and
- Banking and securities regulators to cooperate for the purpose of maintaining equal regulation of bank and nonbank transfer agents.

The law also authorizes the appropriate regulator to penalize transfer agents and natural persons associated with a transfer agent for violations of the law and regulations.

The securities law does not require a transfer agent to be a member, or to comply with the rules, of an SRO.

Transfer agents may choose to be a member of one or more industry associations that are not SROs.

[Notes 166–168]

Obligations of Registered Entities

Broker-dealers, investment advisers, and other entities registered with the securities-regulation agency have continuing compliance and reporting obligations to the securities regulator. In addition:

- A broker-dealer that is a member of one or more SROs has continuing compliance and reporting obligations to each SRO;
- A broker-dealer that is a primary dealer in government securities has continuing compliance and reporting obligations to the government department that issues securities or to the central bank; and
- A settlement facility that is a limited-purpose bank has continuing compliance and reporting obligations to the appropriate banking-regulation agency.

Broker-dealers and other entities registered with the securities regulator, such as investment companies, that are the issuers of registered securities have continuing compliance and reporting obligations to:

- The securities regulator with respect to the issued securities, and
- The exchange if the issued securities are listed with an exchange.

An important objective of the securities law should be to:

- Prevent or eliminate compliance or reporting conflicts, and
- Simplify procedures by which the same information is communicated to the securities regulator and to one or more SROs, other regulators, and exchanges.

A public-accounting entity that audits the financial statements of publicly owned companies is not required to be registered with the securities-regulation agency, but it has continuing compliance and reporting obligations to the auditors' SRO.

[Note 169]